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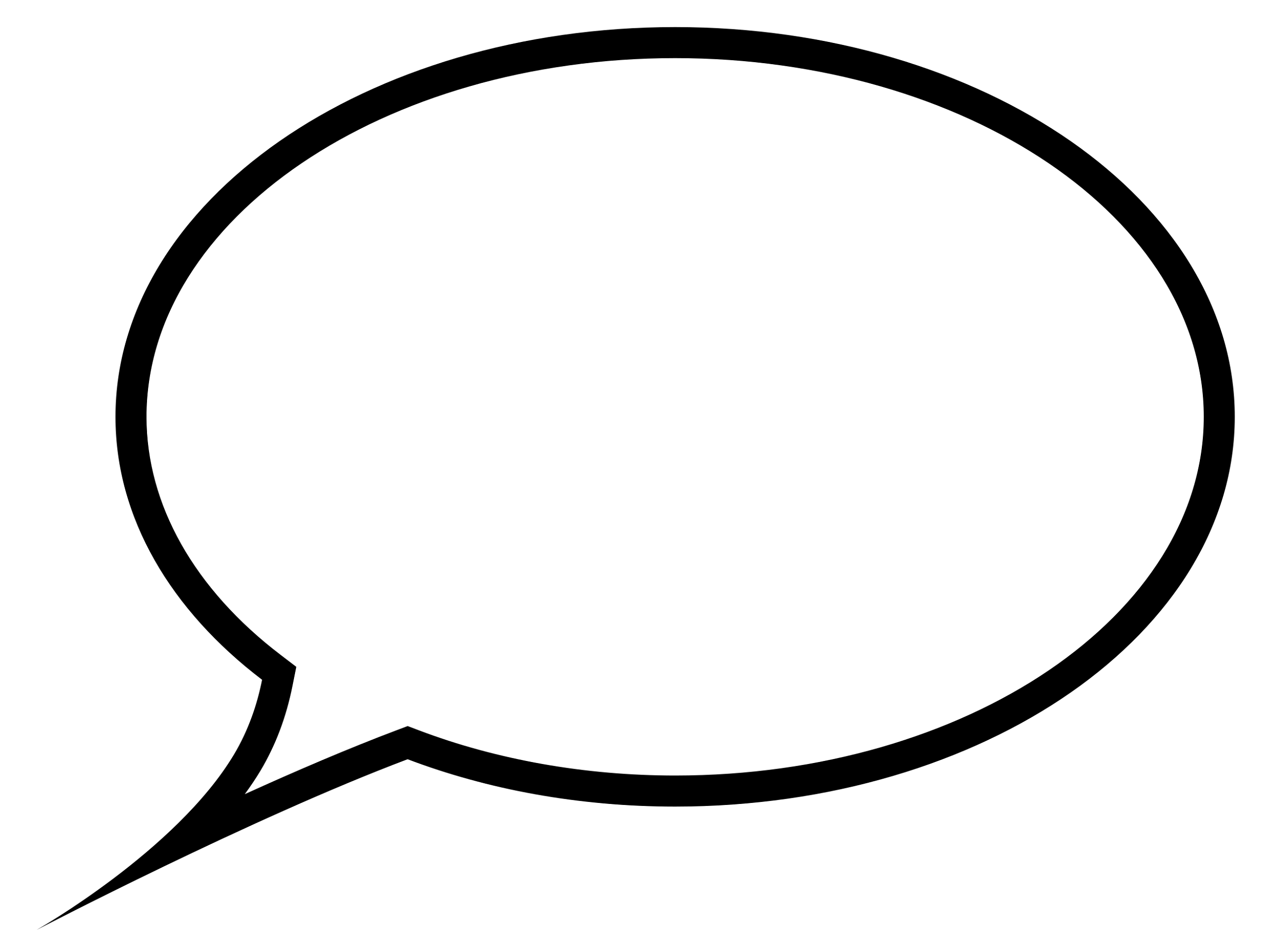
# The Purpose of this Guide

This Practice Guide has been prepared for attorneys advising California Worker Cooperatives formed as California Cooperative Corporations. The goal of this Guide is to provide cooperative lawyers in California with step-by-step procedures for attorneys advising cooperative clients, including tips and tactics, strategic options, and lists of what to consider and how to proceed when advising employee owned enterprises.

** Important Disclaimers:**

The contents of this Practice Guide should not be relied on as legal advice. Some of this information could become outdated, and laws vary from place-to-place. Furthermore, although we tried to collect accurate information and give the laws our best interpretation, some information in this booklet could even turn out to be incorrect or subject to other interpretations by courts or regulators! We sure hope that’s not the case, but, what can we say? Law is complicated stuff! That's why we strongly recommend that you consult with an attorney before using this information to form or operate a cooperative.

This handbook was written specifically for worker cooperative corporations in California. Although some content may be applicable across states, and although some legal matters are governed by federal tax law, anyone using this book should be aware of the necessity to research your own state’s laws.

** Feedback? Questions?**

Please submit your comments using this [feedback form](https://docs.google.com/forms/d/e/1FAIpQLSeklmwl4n0jgjoPZUbqkNrN9b0FwZ_jhTetNBwqu1Y8F68t6w/viewform).

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# Chapter 1: Overview of Cooperatives

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## Introduction

Humans have created innumerable methods of working together to achieve goals and create value for each other, and all across the economy we are seeing more individuals eschew conventional hierarchical and extractive business models in favor of cooperative models.

Most people have a general understanding of what it means to “cooperate” with others, but the exact meaning of the term in practice can vary depending on the context and individuals involved. This is also true for an entity or project considered to be a “cooperative.”

Attorneys in this space who understand the broader context of the cooperative movement will be better prepared to help their clients navigate the options. To preface the rest of this practice guide, this chapter will present the different frameworks used to define a cooperative and the core concepts that are generally applicable to all cooperatively governed and/or managed organizations. It will also discuss various types of formal cooperative structures, provide links to supportive organizations, and introduce the California statutes governing cooperatives. The rest of the guide will cover California-specific legal issues and practices in depth.

## Different Frameworks for Defining “Cooperative”

Cooperatives are not limited to one type of organization, and cooperative businesses manifest in a variety of ways. The term “cooperative” can refer to a specific type of business entity recognized under the law or to the internal governance structure of an organization. Frameworks used to define cooperatives include adherence to shared principles and values, the types of people who own them and benefit from their products and services, and the statutory frameworks that govern them.

## Shared Principles

Some organizations or groups call themselves cooperatives without having formed a Cooperative Corporation or even registering a new legal entity at all. For example, a group of tenants might create a housing “cooperative” simply by adopting highly participatory and democratic ways of operating. Similarly, workers at a nonprofit organization or fiscally sponsored project may elect to operate through cooperative, democratic principles, such as “one person one-vote. Regardless of formal legal structure, it is safe to say that any organization or business that calls itself a cooperative will adhere to the following seven core principles that distinguish cooperative organizations[[1]](#footnote-0):

1. **Voluntary and open membership**. Cooperative organizations are generally understood to be supportive of reciprocally beneficial relationships where coercion and discrimination are not condoned, including in the membership application process. They are open to all persons able to use their services and willing to accept the responsibilities of membership.
2. **Democratic member control**. One-person-one-vote egalitarianism is key to most cooperatives. The people doing the work are also benefiting from the work and making decisions together in a manner that ensures everyone’s views matter.
3. **Member economic participation.** Each member of the cooperative is financially committed and entitled to participate democratically in decisions relating to capital, income and expenditures. Members share in any surplus income they generate and decide democratically how to allocate it, e.g., to develop their cooperative, possibly by setting up reserves; to pay members based on their annual contributions of hours worked, products bought/sold, etc.; and to support other activities approved by the membership.
4. **Autonomy and independence.** Since cooperatives are controlled democratically by their members, remaining autonomous and independent from external control is important. Any partnerships or contractual relationships with other entities must adhere to cooperative principles.
5. **Education, training, and information.** Knowledge is power, and cooperatives prioritize educating the public about the products/services they offer and the benefits of cooperative principles and organizations. They also provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives.
6. **Cooperation among cooperatives.** Cooperation doesn’t end within the walls of each individual cooperative - cooperatives find value in supporting each other locally, regionally, nationally, and internationally.
7. **Concern for community.** Cooperatives are dedicated to much more than generating profits for owners. A genuine concern for the wellbeing of the community motivates cooperatives and their members.

Each cooperative organization, whether it’s a group of friends working together or a legally formed business entity, will have some connection to these seven principles. When faced with forks in the road or ethical dilemmas, returning to these core concepts is a useful framework to help with conflict resolution and decision making.

## Ownership

Cooperatives also differ from other business types based on who owns them. Generally, a cooperative is an organization that is owned by the same people who produce, use, and/or benefit from the products and services offered by the organization. The International Cooperative Alliance’s definition of a cooperative is “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically controlled enterprise.”[[2]](#footnote-1) The types of people who form cooperatives tend to be the types of people who value democracy, equity, equality, solidarity, and inclusiveness. Cooperatives are often formed out of economic, social, and cultural needs and are seen as a means toward collective self-help and self-responsibility. Thus, expanding the reach of cooperatives involves sharing these values with the community and building support amongst those who are aligned with the mission and processes of the organization.

## Statutory Frameworks

Cooperatives can also be defined by state and federal statutes. Business attorneys know that “cooperative” refers to a specific type of corporation recognized under state law. Statutory schemes that govern the formation and operation of cooperative entities exist in most states. The legal requirements for forming a cooperative corporation vary from state to state, and at this time, there is no “uniform” law of cooperatives that applies to all organizations in all states.[[3]](#footnote-2) Therefore, practitioners will need to research the entity formation statutes in their respective jurisdictions to learn what is applicable (see Chapter 3 for entity selection issues in California).[[4]](#footnote-3)

Accountants and bookkeepers working with “cooperatives” know the term refers to a business’ tax status and how they treat any distribution of earnings. This is because federal tax law creates tax procedures for entities that are “operating on a cooperative basis” as those terms are defined under IRS legal precedent, which will be discussed in great detail in the taxation chapter.

| **→ PRACTICE TIP:** The practice of cooperative law is evolving! Remember that clients need help understanding how laws apply to their ideas and they often use legal terms of art without knowing the full legal meaning of those terms. You are the lawyer and offer valuable educational and guidance services. Getting to know your clients and understanding their goals is critical to deciding which entity form will work best for them. It may be a formal cooperative corporation taxed under Subchapter T, or it may be an LLC with cooperative management rules. Or something else. The key is to not assume there is one right way to do the project and keep an open and inquisitive mind as you work with your client . . . cooperatively!  As discussed above, one way to distinguish cooperatives from other entity types is by their membership. The next section introduces common types of cooperatives as differentiated by membership and purpose. |
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## Common Types of Cooperatives

While there is no “one way” to do cooperation, several common frameworks have developed in our economy, and some have even matured into detailed statutory schemes and taxation structures. This section gives a general overview of the various types of cooperative structures lawyers may encounter in this practice. Note that some states create specific laws for specific types of cooperative entities while others apply general non-profit or for-profit corporation laws to all of them. Because each jurisdiction will govern in its own way, it is critical to look up the applicable statutes and practices when determining how to form any of these cooperatives. You can find resources on specific state statutes on [Co-opLaw.org](http://www.co-oplaw.org) and on NCBA CLUSA’s [State Cooperative Statute Library](https://ncbaclusa.coop/resources/state-cooperative-statute-library/) web page.

### Consumer & Producer Cooperatives

Consumer and producer cooperatives are broad terms for entities that are cooperatively managed to produce and/or provide consumable goods and services to their members, and sometimes also to the general public. Consumer cooperatives tend to help the consumers consolidate their buying power to obtain goods at lower prices, and producer cooperatives tend to help the producers maximize efficiency and reach. (Agricultural marketing cooperatives are a type of producer cooperative.) These concepts can be combined, and there is much variety in these types of cooperatives. For instance, cooperatives can be created for health-care services like body work and acupuncture, for childcare and schools, and for food production and grocery stores. The key elements of consumer and producer cooperatives are adhering to the seven general principles described above, membership/patronage requirements, and membership/patronage benefits. They can range from small and private (like a neighborhood preschool co-op owned by parents who need childcare services) to large and public (like a grocery store co-op owned by its regular shoppers that also welcomes all shoppers). Great variety exists from state-to-state in the regulation of consumer and producer cooperatives. Depending on the state, these cooperatives can be formed under specific cooperative statutes or under general corporation laws.

### Agricultural Marketing Cooperatives

Agricultural marketing cooperatives are a specific type of producer cooperative. Through this type of cooperative, farmers join together to collectively obtain marketing and distribution services at a lower price than they could on their own. Many rural states with agriculture-based economies have a long history with cooperative entities designed to support farmers and get their products to market. You may see statutory language such as “to promote, foster, and encourage the intelligent and orderly marketing of agricultural products through cooperation”; “to eliminate speculation and waste”; “to make the distribution of agricultural products as direct as can be efficiently done between producer and consumer”; and “to stabilize the marketing problems of agricultural products.”[[5]](#footnote-4) Agricultural marketing cooperatives can be formed as for-profit or nonprofit entities and can often qualify for state and federal tax benefits and securities exemptions. These organizations can be powerful influencers of state politics if the commodities they represent are integral to the economy.

### Credit Unions

Credit unions are a type of financial cooperative, and can be formed as cooperative corporations. The statutory purposes of these cooperatives will be something along the lines of providing an opportunity for the members to use and control their own money, to promote thrift at a reasonable rate of return, and to provide a source of credit at fair and reasonable rates. In addition to whatever cooperative corporation statutes might apply, credit unions are also highly regulated by state and federal commercial, securities, and consumer protection statutes.

### Housing Cooperatives

Housing cooperatives can also take many forms but are generally multi-family or group living situations where a cooperatively managed entity owns and maintains the building(s) and the entity is owned by cooperative members who are also residents. Residents do not own their units separate from the cooperative. Thus, depending on the structure, the cooperative may restrict the rights of members to sell their interests, and therefore access to their units, on the open market. Housing cooperatives can serve to protect communities against real estate speculation and gentrification while also building community and long-term financial stability for resident owners. Housing cooperatives are also subject to fair housing laws and planning and zoning ordinances, which are important to keep in mind when helping to form or advise them as clients.[[6]](#footnote-5)

### Utility Cooperatives

Communities have long had to band together to provide water for drinking and irrigation, electricity or gas for power and heat, telephone service, and waste management. States with rural populations far away from urban centers and centralized power supplies tend to have more utility cooperatives. They are generally structured as nonprofit corporations with members that are geographically related and collectively responsible to pay for the costs associated with managing and benefiting from these services. Even urban areas can benefit from utility cooperatives - for example, neighbors can collectively purchase solar power generating and distribution systems to power their subdivisions. Utility cooperatives are also regulated under complex utility and safety regulations and other statutory frameworks that govern the consumption of natural resources and generation of pollution.

### Worker Cooperatives

Worker cooperatives will be discussed in great detail in the chapters that follow. Generally, a worker cooperative is a business owned by, democratically governed by, and operated for the benefit of the workers. They provide an opportunity to eliminate the conventional “master-servant” relationship that characterizes many employment opportunities. Worker cooperatives can empower workers and communities by connecting the financial risks and rewards of business ownership with the labor that is needed to succeed. While some states have formal worker cooperative statutes, many others do not, and their “worker cooperative” models can be found in corporations or LLCs that have formalized cooperative management and profit sharing principles into their processes.

## Distinctions between Worker Cooperatives & Worker-Owner Benefit Programs

The term “worker ownership” does not necessarily mean cooperative management or formal cooperative structure. Some companies allow their workers to purchase stock in the company or earn stock as a form of compensation. The rights that this stock ownership conveys will depend on how the company is structured.

“Employee Stock Ownership Plans”, known as “ESOPs”, are regulated by federal law set forth under the [Employee Retirement Income Security Act of 1974](https://www.dol.gov/agencies/ebsa/laws-and-regulations/laws/erisa) (ERISA) and related retirement plan laws. Put very simply, an ESOP is created when a corporation creates a trust fund that manages shares owned by employees. The company usually gives the shares to the employees in trust as part of a benefit package. The trustee is obligated to manage the shares in a way that will benefit the employee-shareholders. The employee-shareholders are entitled to financial benefits such as dividends, and thus will benefit when the company is profitable. ESOPs often allow the employee-shareholders to vote in annual Board of Director elections, which gives the employees some say in management. However, the employees are not part of day-to-day management decisions and their management authority is limited to these major annual votes. Given the administrative and regulatory requirements for ESOPs, they are usually found in larger corporations with the resources to hire staff to manage compliance.

Some corporations offer their workers stock options, meaning the employees are allowed to buy shares or are awarded shares over time as part of their compensation packages. These workers become shareholders and are entitled to financial and management rights according to the terms of the corporation’s bylaws and shareholder agreements. These employee-shareholders are technically worker-owners, but they tend to be minority shareholders with limited managerial power.

In contrast, worker cooperatives at their core are about workers governing the business and sharing in the risk/reward of ownership in equitable, democratic ways. So remember that while all worker cooperatives are worker owned, not all entities that allow workers to own shares in the business are worker cooperatives.

## 

## Overview of California Statutory References to Co-ops

California’s general cooperative corporation (the legal entity) is governed by the [California Corporations Code §§ 12200 to 12704](https://leginfo.legislature.ca.gov/faces/codes_displayexpandedbranch.xhtml?tocCode=CORP&division=3.&title=1.&part=2.&chapter=&article=) and came into effect January 1, 1984 with some amendments, including those made by AB 816, the Worker Cooperative Corporation Act (see below). Also, many people have a misconception that cooperatives act like or are nonprofits and therefore are tax-exempt, but cooperatives incorporated under the California Cooperative Corporation Law will find it virtually impossible to attain tax-exempt status, primarily because a cooperative is established to further the mutual benefit of its members and not the general public.

**Legal purpose of Cooperative Corporations**: Cooperative corporations “are democratically controlled and are not organized to make a profit for themselves, as such, or for their members, as such, but primarily for their members as patrons.” ([Cal. Corp. Code § 12201](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12201.))

At their legal core, cooperatives are obligated to give members only a few basic governance rights, including:

* The right to an equal vote in the election of the Board ([Cal. Corp Code 12253](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12253.)),
* The right to request and vote in an action to remove Board members ([Cal Corp Code 12362](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=12362.&lawCode=CORP)),
* The right to take part in at least one member meeting per year ([Cal Corp Code 12460](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=12460.&lawCode=CORP)),
* The right of access to information about the cooperative, its members, its Board meetings, and finances ([Cal Corp Code 12591](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12591.)), and
* The right to approve/disapprove dissolution, merger, and other major decisions ([Cal. Corp Code 12330](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12330.)).

**Built-in democratic structure:** Per [Cal Corp Code Section 12480](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12480), “each member entitled to vote shall be entitled to one vote on each matter submitted to a vote of the members.”

**Exclusive and mandatory use of “Cooperative:”** Except for a few exceptions for other types of cooperatives, only those incorporated as a California Cooperative Corporation are allowed to use the term “cooperative” in their name. In fact, all corporations formed as a California cooperative corporation *must* use the term cooperative in their name. ([Cal. Corp. Code § 12311](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=12311.&lawCode=CORP))

**Cooperative Member Exemption**: This allows securities exemptions for member shares up to $1,000 per person. It’s basically the only form of legal crowd financing in CA requiring no federal or state notice or registration. See CA Corp Code section 25100(r).

* [**Cal Corp Code 25100 (r)**](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=25100.) **:**any shares or memberships issued by any corporation organized and existing pursuant to the provisions of Part 2 (commencing with Section 12200) of Division 3 of Title 1, provided the aggregate investment of any shareholder or member in shares or memberships sold pursuant to this subdivision does not exceed one thousand dollars ($1,000). This exemption does not apply to the shares or memberships of that corporation if any promoter thereof expects or intends to make a profit directly or indirectly from any business or activity associated with the corporation or the operation of the corporation or from remuneration, other than reasonable salary, received from the corporation. This exemption does not apply to nonvoting shares or memberships of that corporation issued to any person who does not possess, and who will not acquire in connection with the issuance of nonvoting shares or memberships, voting power (Section 12253) in the corporation. This exemption also does not apply to shares or memberships issued by a nonprofit cooperative corporation organized to facilitate the creation of an unincorporated interindemnity arrangement that provides indemnification for medical malpractice to its physician and surgeon members as set forth in subdivision (q).

**Built-in non-extractive finances**: CA Cooperative Corporations have a 15% cap on annual return on capital investment (Corp Code 12451).

* **At cost operations (for worker coops, this is also the wealth creation part!):** Profits should be used to benefit members, including returned to members on the basis of their “patronage” (how much they purchased, how much they worked, or another form of patronage). Cooperative Corporations “conduct its business primarily for the mutual benefit of its members as patrons of the corporation. The earnings, savings, or benefits of the corporation shall be used for the general welfare of the members or shall be proportionately and equitably distributed to some or all of its members or its patrons…” ([Cal. Corp. Code § 12201](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12201.))

## Worker Cooperatives Under California Law

Worker Cooperative provisions exist within the Cooperative Corporation code §§ [12200](https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?division=3.&chapter=1.&part=2.&lawCode=CORP&title=1.&article=1.) to [12656.5](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=12656.5.&lawCode=CORP) laid out above with special provisions that directly relate to the legal rights and obligations of worker cooperative corporations.

**Defining Worker Cooperative**: [Cal Corp Code 12253.5](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12253.5.) Defined a worker cooperative & requires that 51%+ of workers be members or candidates.

* “Worker cooperative” or “employment cooperative” means a corporation formed under this part that includes a class of worker-members who are natural persons whose patronage consists of labor contributed to or other work performed for the corporation. Election to be organized as a worker cooperative or an employment cooperative does not create a presumption that workers are employees of the corporation for any purposes. At least 51 percent of the workers shall be worker-members or candidates.

**Reduced meeting notice requirements for “collective board” worker cooperatives**: [Cal Corp Code 12461](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12461.) (“A worker cooperative shall provide notice of the meeting not less than 48 hours before the meeting if the meeting is a meeting of only worker-members, provided that the notice is delivered personally to every worker-member.” ) and [Cal Corp Code 12460.5](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12460.5.) (collective board worker cooperatives are not required to hold an annual meeting).

**Community Investor Exemption**: Ability to raise capital from “investor-members,” aka the general public, for up to $1000. A worker cooperative corporation includes a special category of investor, the “community investor,” who is not a worker-member, but rather a person who invests money in the cooperative with the expectation of a limited return and limited voting rights.

* [Cal Corp Code 12253 (c)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12253.) Community investor voting power in a worker cooperative shall be provided in the articles or bylaws, and is limited to approval rights only over a merger, sale of major assets, reorganization, or dissolution. Approval rights shall not include the right to propose any action.

# Chapter 2: Role of an Attorney

*Brett Heeger, Esq. and Alexandra Glancy, Esq.[[7]](#footnote-6)*



## Introduction

This chapter discusses the practical and ethical concerns that arise in the process of establishing and terminating a relationship with a client organized (or organizing) as a California cooperative corporation. Before drafting any attorney-client engagement agreement, the attorney must consider not only various practical and business matters but also any ethical issues raised by the California Rules of Professional Conduct, the California Business and Professions Code, bar association ethics opinions, and any applicable court rules.

This chapter is written with an eye toward practical and ethical issues arising in major corporate matters, such as formations, mergers, conversions, or dissolutions, rather than issues such as contract drafting and negotiation that are less likely to present unique issues to cooperative corporations.

The attorney must first gather information to determine whether representation of the client is appropriate and whether they possess the necessary experience and skill related to the subject matter of the representation. Before engaging in any representation, the attorney must also identify any conflicts of interest that may exist between any participants or entities involved, the attorney, and/or any other relevant parties. If representation is found to be appropriate, the attorney and client can work together to define the scope of representation, establish the responsibilities of each party, and execute any necessary agreements.

## 

## Professional Responsibility Considerations

### Getting to Know Your Client and Determining Whether Representation Is Appropriate

Before agreeing to represent a client in the formation of a cooperative, the attorney must first determine whether representation is appropriate. The attorney must obtain adequate information to identify whether they have (or can readily obtain) sufficient knowledge and skill for the task and whether there are any present or potential conflicts of interest.

| **→ PRACTICE TIP:** *Initial Consultations and Confidentiality*  Irrespective of whether or not the attorney accepts the engagement, the attorney has a duty to protect confidential information collected from a potential client during an initial consultation.[[8]](#footnote-7) You may consider explicitly telling your clients this fact so that they feel comfortable giving you a full picture of the scope of representation needed and issues that may arise. For example, you would like to know in advance if some of the members of a prospective new cooperative lack documentation to legally work in the U.S. (See the *Employment and Labor Law Considerations Chapter* of this guide for more detail on this particular matter.) |
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Notwithstanding the attorney’s confidentiality obligations, many attorneys and law firms will run a conflicts check early on prior to a substantive consultation and at the start of much of this due diligence. Completing this check early reduces the risk of conflicts of interest and, should there be a conflict, saves the attorney time.

The attorney should gather enough preliminary information from the prospective client to determine the amount of work that will be required and the scope of representation. For example, although the client may have requested legal support in setting up a cooperative corporation, the attorney should attempt to use this preliminary stage to determine if the client fully considered and ruled out alternative business entities.

The preliminary information sought from the prospective client should generally include the following:

* The identities and business affiliations of each of the principals of the cooperative (e.g., prospective members, officers, employees, other shareholders);
* The identities and business affiliations of those persons or entities that have or are expected to enter into a material relationship with the cooperative (e.g., consultants, lenders, investors, distributors, suppliers);
* The anticipated start-up budget, or current revenues and available capital for an existing business;
* Any ownership of real or intellectual property to be used by the cooperative (e.g., office space, trademarks, licenses);
* A summary of the business operations of the cooperative; and
* Identification of any major questions or concerns from the client’s leadership team, whether related to legal or business matters.

| **→ PRACTICE TIP:** *Assessing and Coaching Client Readiness to Form a Cooperative Corporation*  Forming an entity with the help of an attorney can bring lots of benefits to the client, from liability protections to strengthened and more-transparent governance. If a prospective client comes into your office, that’s a good sign that they appreciate some or all of those benefits. But forming and managing a cooperative corporation takes time and attention. It can also be costly—the entity will need to pay annual taxes on an ongoing basis, in addition to legal, accounting, and other fees necessary to form and maintain the legal entity. Taking certain steps to help ensure your new client’s readiness for a significant legal project can result in more-efficient and better results, as well as higher client engagement and satisfaction.  For example, prospective members of a new cooperative with little to no prior experience as owners may have a lot to learn about cooperatives as a whole, from group decision-making tools to basic concepts and vocabulary around patronage and financial matters. And though the attorney may be able to walk the prospective members through that material, it may be easier and more cost-effective for the prospective members to instead take a course offered by a cooperative developer, have conversations with other cooperatives operating in their field, and/or study resources like the Think Outside the Boss[[9]](#footnote-8) manual on their own. In addition to saving time and legal expense in the process, gaining independent knowledge can also empower the clients to form their own ideas around how their cooperative can be run.  There is also the more general matter of finding the appropriate time for a new business to form a legal entity. Before advising a client on a new business, the attorney should ensure that the prospective client is prepared with a business plan. All sides would be disappointed if a client took on the expense and effort of forming a cooperative corporation and drafting bylaws, and two months later decided to dissolve the business because there was no viable pathway to financial sustainability for the new entity. In short: talk with your client about their business plan and operations. |
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### Assessing the Attorney’s Competence

The attorney has a duty to reject any representation that would violate any state’s Rules of Professional Conduct or the State Bar Act, or when the attorney’s mental or physical condition impairs their ability to effectively represent the client.[[10]](#footnote-9) At the very least, the attorney should be able to identify any potential conflicts of interest before further discussing significant confidential information and to prevent any unnecessary delay to the client if the client must ultimately be referred to another attorney.

The attorney has a duty to perform legal services with competence.[[11]](#footnote-10) Competence is defined as the “(i) learning and skill, and (ii) mental, emotional, and physical ability reasonably necessary for the performance of such service.”[[12]](#footnote-11) The attorney violates this rule when they intentionally, recklessly, with gross negligence, or repeatedly fail to competently perform legal services.[[13]](#footnote-12) The attorney is obligated to represent a client with “such skill, prudence, and diligence as lawyers of ordinary skill and capacity commonly possess and exercise in the performance of the tasks which they undertake.”[[14]](#footnote-13) The standard of care requires the attorney to perform as other attorneys under similar circumstances in the same community. Wright v. Williams, 47 Cal. App. 3d 802, 809 (1975).

Advising on cooperative corporations requires competence in the law of business organizations but also may involve knowledge of securities regulation, taxation, labor and employment law, family law, contract law, real property law, and intellectual property law. Try to use the initial consultation to assess which, if any, of these areas may also be implicated by the proposed representation.

If the attorney does not have the requisite competence, they can still provide competent legal services by either:

* Associating with or professionally consulting with an attorney who they reasonably believe to be competent;
* Acquiring sufficient learning and skill before performing legal services; or
* Referring the matter to an attorney who they reasonably believe to be competent (Cal. Rules of Prof. Cond. 1.1[c]).

| **→ PRACTICE TIP:** *Acquiring Sufficient Learning*  This handbook is intended to be a resource for attorneys seeking to broaden their competence to advise cooperative corporations. By reading this handbook, you are increasing your competence. |
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### Representing an Organization

Specific ethical guidelines apply to an attorney representing an organization.[[15]](#footnote-14) When the client is the organization, the attorney must explain to other constituents involved—including members, managers, employees, investors, and shareholders of the organization—that they represent the organization. The attorney should remind constituents that they solely represent the organization (i) at the beginning of the engagement and (ii) at any time when the attorney knows or reasonably should know that the interests of the organization are adverse to those of the constituents.[[16]](#footnote-15) In addition to stating who the attorney represents, it is also important to make clear who the attorney does not represent.

| **Form Language:** In addition to voicing reminders where there is apparent confusion, the attorney should include clarifying language in the engagement agreement, along the lines of the following:  *We will represent only the client as an entity in this engagement and will not represent the current or proposed members, directors, or officers of Client. Such members, directors, and officers should seek independent, separate counsel in this matter.* |
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Notwithstanding the foregoing, Cal. Rules of Prof. Cond. 1.7 does permit the attorney to represent both the organization and any of its constituents even where conflicts of interest may be present, granted that informed written consent is acquired from each party. Such an arrangement should be entered with caution. (See the Section on “Navigating Conflicts While Representing Multiple Parties,” below.)

| **→ PRACTICE TIP:** *Representing Solely the Entity on Internal Corporate Matters*  There may be occasion for the attorney to represent a cooperative on matters that necessarily implicate the rights and obligations of the cooperative’s members, such as drafting or amending a cooperative corporation’s bylaws. Clarifying disclaimers such as the form language above are especially important when working on such projects.  In addition, and especially where the attorney is aware that some or all of the members have not in fact engaged independent counsel, the attorney should take care to act neutrally among the members when crafting provisions. Like a third-party mediator, or even a waiter in a restaurant, it is the attorney’s role to present options, advise the members on the implications and details of such options, and in some cases even facilitate decision-making between and among the parties. The attorney should seek to avoid the appearance of representing one party or set of interests over others by regularly reaffirming the attorney’s role; maintaining regular and open communication on the questions at hand; and, where necessary, declining to advise on issues raised specifically by one party to promote their own interests. |
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### Conflicts of Interest

#### Introduction

The attorney should take good care to identify early any conflicts of interest. A conflict of interest may arise if the attorney’s representation of a client is directly adverse to that of another client in the same matter or in a separate matter. Id. In addition, a conflict of interest may be present if there is a significant risk that the attorney’s responsibilities to or relationships with another client, former client, or third person will materially limit the attorney’s representation of the client. This also applies to limitations presented by the attorney’s own interests. Id. However, where two parties are clearly adverse in an engagement, courts have found that no conflict is present if the parties have agreed to the terms of the agreement in advance and the attorney acts (and specifies in advance that they are acting solely as) a scrivener to record the agreement.[[17]](#footnote-16) This “scrivener” role should be entered into cautiously, if at all, and with disclosure to the clients that withdrawal from representation may be necessary should a conflict arise.

In complying with Rule 1.7, the attorney must not represent multiple parties with actual or potential conflicts of interest without first receiving the informed written consent of each party. Even where consent is obtained, the attorney must not proceed with the representation unless the attorney reasonably believes that (i) they can provide competent and diligent representation to the clients; (ii) the representation is not illegal; and (iii) the representation does not involve a claim by one client against another client represented by the attorney in the same litigation.[[18]](#footnote-17)

Note that this is an ongoing obligation. Even where a potential conflict may initially be waivable, changes in circumstances (such as the clients entering into litigation) may force the attorney to withdraw from representing one or both of the clients.

In addition to identifying and mitigating conflicts of interest, the attorney owes these related duties to a client:

* The duty to maintain client confidences and secrets;[[19]](#footnote-18) and
* The duty to keep clients reasonably informed and to promptly respond to status inquiries and requests for information made by clients.[[20]](#footnote-19)

#### Navigating Conflicts While Representing Multiple Parties

While representing cooperatives, conflicts of interest may arise when several individuals have interests in the cooperative but only one attorney is retained. For example, attorneys who are hired to form a business entity may be asked to represent multiple individuals, even though drafting bylaws will define or otherwise implicate the interests of and relationships between the parties and may ultimately surface inherent conflicts. As another example, the attorney may be asked to represent both the entity and its members. These scenarios may often be the result of a desire to reduce legal fees or to facilitate community organizing and development, both typical objectives in the formation of a cooperative.

The interests of each party may differ with respect to important elements (e.g., capital investments, allocations of profits and losses, and tax considerations), and ideally, each party should have separate counsel. Ultimately, the attorney must consider whether it is possible or advisable to represent the parties as a group or whether the inherent conflicts are so great as to require separate representation.

If the attorney believes it is possible to advise multiple parties, the attorney must disclose the potential conflicts of interest and seek informed written consent from all parties. The attorney should describe the potential conflicts in detail within the engagement agreement, even adding extra paragraphs on the matter.[[21]](#footnote-20) A blanket conflict waiver in an engagement letter will not be sufficient to constitute informed written consent and is considered against public policy.[[22]](#footnote-21) If the conflicts of interest are disclosed to each party and the informed written consent of each party is received, the joint engagement may be accepted.

The attorney should also explain that all information learned by the lawyer from any source will be disclosed equally to all clients in the representation. Further, communications between and among the clients and the attorney during the engagement could be disclosed in litigation between or among the clients and/or the attorney.

Finally, even after obtaining informed written consent, the attorney should continue to let clients know if new conflicts arise and obtain renewed consent to continue the representation as new conflicts come to light. The attorney reserves the right to withdraw from the representation if the attorney concludes that a non-waivable conflict of interest exists. (See Section 2.4.1, “Introduction,” above for a discussion of Cal. Rules of Prof. Cond. 1.7(d) and those general conditions that must be met to enter into representation of a client in addition to obtaining appropriate consent.)

#### Conflicts Between Attorney and Client

In the following circumstances, the attorney cannot accept or continue representation of a client without written disclosure to and consent by the client:

* The attorney has, or knows that another attorney in their firm has, a personal, professional, legal, financial, or business relationship with or responsibility to a party in the same matter.[[23]](#footnote-22)
* The attorney knows or reasonably should know that another party’s attorney is a spouse, parent, child, or sibling of the attorney; is the attorney’s client or the client of another attorney in their firm; or has an intimate personal relationship with the attorney.[[24]](#footnote-23)

Keep in mind that this disclosure and consent is required in addition to the general requirements of compliance with terms of Cal. Rules of Prof. Cond. 1.7(d), discussed in the “Introduction” section, above.

##### Attorney as Member, Director, or Officer of Client

In some cases, the attorney may also be a member of the cooperative or asked to serve as a director or officer of a cooperative. If the attorney is interested in serving in the director or officer role, they should consider resigning as outside counsel. Some drawbacks to serving in multiple roles may include the following:

* The attorney’s advice may be less independent, therefore potentially subjecting the attorney to liability or conflicts of interest.
* Because of the attorney’s profession and training, they may be held to a higher standard of conduct as a director or officer than would a non-attorney serving in the same capacity.
* Others may rely on the attorney’s statements as “legal advice” even when they are made as a director or officer in a business context.
* If the attorney receives compensation or other economic benefits from their role as director or officer, they may be subject to Cal. Rules of Prof. Cond. 1.8.1: Business Transactions with a Client and Pecuniary Interests Adverse to a Client. Rule 1.8.1 would certainly be implicated if the attorney becomes a member with the prospect of patronage dividends. Rule 1.8.1 is discussed in detail in the section entitled, “Business Between Attorney and Cooperative,” below.

The attorney should consider the above issues before accepting an officer or director position. The bottom line is that the attorney’s independence of judgment must not be impaired, as this may become a source of liability for the attorney and jeopardize the quality of legal counsel for the client.

| **→ PRACTICE TIP:** *Check the Cooperative’s Own Policies and Conflict of Interest Rules*  In addition to the legal professional rules and obligations, the attorney should also consider the applicability of any laws or policies implicated in their capacity as the director, officer, or member, as applicable. For example, Cal. Corp. Code § 12373 governs contracts or transactions with a cooperative corporation as well as conflicts of interest between a director and a cooperative corporation. The cooperative itself may have a conflict of interest provision in its bylaws, or other policies or rules regarding doing business with members, directors, or officers. |
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##### Business Between Attorney and Cooperative

Conflicts of interest arise if an attorney enters into a business transaction with a client or knowingly acquires an interest adverse to the client. Cal. Rules of Prof. Cond. 1.8.1. Rule 1.8.1 is typically implicated by business transactions that arise after an attorney-client relationship has already been established. Additional conflicts may arise if an attorney provides goods or nonlegal services to a client. An attorney is prohibited from entering into this type of business transaction or acquisition, unless the following requirements are satisfied:[[25]](#footnote-24)

* The terms are fair and reasonable as to the client.
* The terms, along with the lawyer’s role in the transaction, are fully disclosed in writing to the client in a manner that should reasonably be understood by the client.
* The client is advised in writing to seek independent legal advice and is given a reasonable opportunity to seek such advice.
* The client provides informed written consent to the transaction and the attorney’s role in it.

Entering into a business transaction with an existing client may present an attorney with conflicts of interest and should be thoughtfully considered.

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## Scope Of Attorney’s Role

### Range of Responsibilities

The scope of services provided by the attorney will range from one client to another. The attorney may be asked to advise a client on ongoing business matters or to represent a client during a specific transactional event. Due to the different needs of each client, the attorney and each client must work together to outline the scope of services and corresponding fees for those services. Clear communication is important throughout this process.

### Maintaining Communication Between Attorney and Client

At the start of the representation, it is important for the attorney and client to identify the person or persons who will represent the client in communications with the attorney and who have the authority to make decisions on behalf of the client. This information may be included in the engagement letter. The attorney may also need to maintain communication with the client’s other professional advisers. These may include accountants, nonprofit organizations, tax advisers, or any other attorneys.

In general, the content of attorney-client communications should keep the client reasonably informed of any significant developments.[[26]](#footnote-25) The attorney’s role is to consult with the client and provide the client with the information needed in order to make informed decisions.[[27]](#footnote-26)

| **→ PRACTICE TIP:** *Working with Committees*  Especially where the cooperative is large, talk with your client about establishing a committee or point people for you to work with on the assigned project. This can lead to valuable efficiencies in reviewing documents and making decisions. Be sure to also discuss the authority and reporting obligations of that committee. If a committee needs to present a proposal or new set of bylaws to the membership and/or board, it will be important for you to (i) understand how that might impact the timeline of your services and (ii) ensure your fee estimate (if any) accounts for any time you might need to spend at additional meetings with constituents other than the committee and/or receiving and addressing feedback from a larger body of constituents. |
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### Providing Business Advice as Well as Legal Counsel

The attorney’s role in a project can vary substantially. In some cases, the client may ask for business advice as well as legal counsel. In other cases, the client may wish for the attorney to comment on very specific legal matters. For some projects, such as formations, conversions, or acquisitions, the attorney may be called upon to coordinate the entire project, requiring tax or other advisers to provide input where needed to get the deal done. By the nature of their role, the attorney may have previously participated in similar projects or deals, giving them valuable perspective to lend to the client. To best serve the client’s needs, business and legal advice may end up intertwined.

When the attorney provides business advice, they must comply with the same professional standards as those providing legal advice.[[28]](#footnote-27) Accordingly, it is best to limit business advice to the attorney’s areas of expertise.

### Participation of Nonparties

The attorney must follow specific guidelines when nonparties participate in the representation. This scenario is of particular importance in the formation of a cooperative, for example, as it is often the case that cooperative developers and nonprofit incubators initiate the formation of community-based cooperatives. Other specialists, such as accountants or tax counsel, may also be involved in a project, particularly around formation or cooperative conversions.

#### Working with a Cooperative Developer

If the attorney is working with a cooperative developer or nonprofit incubator in the formation of a cooperative, the attorney should clarify who the client is and the roles of each constituent in the representation. Even (and in some cases, especially) in a group setting with other new cooperatives, developers can help current and former members discuss important decisions, research strategies and tools utilized by other cooperatives, and experiment with different decision-making or other methods that may eventually be formalized into a document with the assistance of a lawyer (such as bylaws or a key contract). In doing so, the developer can save the attorney substantial time educating the client about the same matters and, in turn, save the client substantial legal fees. Courses offered by cooperative developers and incubators can also be great opportunities for new cooperative members to gain an understanding of basic principles and themes that likely informed the substance of documents drafted by founding members of the cooperative (such as bylaws). For situations where a cooperative developer or nonprofit incubator is also a client, please see the section entitled, *“Navigating Conflicts While Representing Multiple Parties,”* above.

| **Form Language:** Where a developer may be facilitating or engaged in a specific project on behalf of the client, the attorney should obtain consent from the client in the attorney’s engagement letter to communicate with this third party regarding that project, along the lines of the following:  *The client authorizes us to communicate with [cooperative developer] in all matters related to our engagement as described herein, and we are authorized to rely on their instructions and communications to us.* |
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#### Working with Accountants

An experienced accountant can add substantial value to a number of projects for a cooperative corporation. In the formation stage, for example, they can provide support and review of tax elections and finance-related sections of the bylaws. Input from tax advisers will be essential to the seller in a cooperative conversion, as tax matters often dictate, among other things, the form of the sale. But an employee (or other) group buying a business may also benefit from an accountant’s input as they conduct due diligence on the company to be acquired. (For additional detail on tax matters for cooperative corporations and conversions, please see the *Income Taxation of Cooperatives and their Members Chapter* of this guide.)

| **→ PRACTICE TIP:** *When Clients Don’t Want to Hire a Tax Adviser*  Some clients may wish to save money by not using an accountant, which may place additional burden on the attorney to provide both tax and financial advising. The attorney should carefully assess and communicate to the client their experience and expertise in these matters. Where the attorney is not in a position to provide tax advice, that should be stated to the client in writing, preferably in the engagement agreement. |
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#### Receiving Fees from a Third Party

Cal. Rules of Prof. Cond. 1.8.6 sets out specific guidelines for when an attorney receives compensation from one other than the client. The attorney is prohibited from entering into an agreement to accept compensation from a nonparty for representing the client unless (Cal. Rules of Prof. Cond. 1.8.6):

* The nonparty does not interfere with the attorney’s independent professional judgment or with the attorney-client relationship;
* Confidential information of the client is protected from disclosure in accordance with Cal. Rules of Prof. Cond. 1.6 and Bus. & Prod. Cond. § 6068(e); and
* The attorney obtains the client’s informed written consent before entering into the agreement for compensation, or as soon as reasonably practicable. No disclosure or consent is required if the attorney is rendering legal services on behalf of a nonprofit that provides legal services to the public.

| **Form Language:** You may obtain this consent via email or separate agreement, or you may incorporate this informed written consent into the engagement agreement, along the lines of the following:  *We understand that the client’s fees and expenses, if any, will be paid by a third party, namely [third party payor]. In signing below, the client agrees to waive any restrictions on third parties in general or [third party payor], in particular paying for all or part of the legal services fees for the services.* |
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### Written Fee Agreements

In most circumstances, fee agreements for legal services in the formation and counseling of business entities, including cooperatives, must be in writing. Bus. & Prof. Cond. § 6148. Specifically, the fee agreement must be in writing for non-contingent fee agreements in which it is reasonably foreseeable that total expense to the client will exceed one thousand dollars ($1,000).[[29]](#footnote-28)

Due to the nature of most corporate transactions such as cooperative formations, contingent fee agreements are uncommon and thus will not be discussed in depth here. Where the attorney is considering a contingent fee, they should carefully review applicable law and professional responsibility rules, and exercise caution generally to ensure that their ability to objectively advise the client is not impaired by incentives to trigger additional fees.

A non-contingent fee agreement must include:[[30]](#footnote-29)

* the basis of compensation (e.g., hourly rates, statutory or flat fees) and any other standard rates, fees, and charges applicable to the representation;
* the general nature of legal services that will be provided to the client; and
* the responsibilities of the attorney and client in the performance of the agreement.

If the fee agreement does not comply with any of the above provisions, the agreement is voidable at the option of the client.[[31]](#footnote-30) However, even if the fee agreement is voided, the attorney will be entitled to collect a reasonable fee for services already rendered.[[32]](#footnote-31)

An unwritten fee agreement is still enforceable in some circumstances, including:

* if the client is a corporation;
* if, after full disclosure, the client knowingly states in writing that a written fee agreement is not required;
* if an arrangement is implied by the fact that the client has previously paid for and the attorney has previously rendered to the client services of the same general kind; and
* if a writing is otherwise impractical or if services are rendered in an emergency to avoid foreseeable prejudice to the rights or interests of the client.

Even if a written fee agreement is not required, it is good practice to provide a client with one. The necessary components of a fee agreement help to identify who the client is, outline the relationship between the attorney and client, and create some transparency and accountability between attorney and client.

| **→ PRACTICE TIP:** *Fee Estimates*  Not surprisingly, prospective clients will be concerned about the costs of legal work. But even experienced attorneys frequently have trouble providing reliable estimates because the details of the matter may not be entirely revealed based solely on an initial consultation. In addition, decision-making by cooperatives and among their members can be a slow process. As input is collected from members and other appropriate parties, members may disagree or change their mind over the course of representation as new facts and opportunities come to light.  When attempting to estimate a fee amount for forming a new cooperative, examples of items to consider include:   * the members’ experience with cooperatives, including as members of other cooperatives; * whether the members have completed any courses, cooperative developer programming, or any other education on cooperatives prior to beginning the formation process; * the attorney’s experience with cooperatives, or access to forms and practice guides; * the similarity of the anticipated cooperative to other cooperatives the attorney may have formed in the past (especially important for the use of forms); * whether draft materials will need to go through more than one round of review and approval (e.g., first to a drafting committee and then to full membership); * whether there will be more than one class of members; * whether the new cooperative seeks to develop PowerPoint or cartoon bylaws, or other special features; * any discounts you may be willing to offer the client; and * additional costs associated with the project, such as filing fees or registered agent fees.   In the end, the attorney should seek to provide a good faith estimate for each phase of work and advise the client of key assumptions and variables that may impact the final amount. It is important to update the client if these assumptions change during representation in such a manner to affect the anticipated final fee amount. Good communication that minimizes surprises on both sides will go a long way, even where an initial estimate ends up quite off base. |
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| **→ PRACTICE TIP:** *Fixed Fees*  In some circumstances, prospective clients may request, or you may offer, your services at a fixed fee rate. Fixed fees can be great tools, especially for new clients. They can allow space for broader conversations and discussion, as you and the clients are less likely to fret the ticking billing clock in the background. Fixed fees can be very helpful to clients for budgeting purposes, especially if they are in the start-up phase. Having a fixed amount for legal fees can be especially helpful for clients seeking to fundraise for legal expenses and other start-up costs from donations, or if they are budgeting for a loan request or similar project.  When deciding whether to offer a fixed fee, and for what amount, issues to consider include:   * Your experience with that particular project; * Whether the project involves negotiations, particularly with third parties, as there is little you can do to gauge the other side’s responses; and * How necessary the fixed fee is to the client’s willingness to hire you.   At their best, fixed fees are reasonably close to the final cost if the time has been billed hourly, with both the client and you sharing the risk of overpaying or underbilling, respectively. Capping your fees is also an option. Fee caps, however, put the entire risk on the attorney and may alter the pace of the representation once the cap is reached.  Even where you provide services at a fixed fee, you should continue to record your time. Recorded hours can be an important record in case any disputes arise with the client and can provide a useful data point for fixed fees or estimates you offer in the future. In addition, even where a fixed or capped fee results in underbilling, there can still be substantial positive benefits to the attorney such as the certainty of payment on a project, building experience in a project type, supporting and building a relationship with a values-aligned client, and more. |
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## Special Issues For Cooperative Conversions

### Introduction

Cooperative conversions may present unique ethical issues to an attorney. A cooperative conversion is best compared with a merger or acquisition: it is a major shift in the ownership structure of a business involving multiple parties with divergent interests that requires thoughtful planning and careful execution. A cooperative conversion may be among parties with a long, friendly history, but one or both parties may, and in many respects should, treat it just like any other sale of a business. In the most basic terms, a cooperative conversion is the transfer of a business. Given the naturally opposing interests of the “buyer” (the employee group or existing cooperative) and the “seller” (the current business owner[s]) in this transaction, a cooperative conversion often requires that each group obtains its own legal representation. In limited situations, joint representation or other efficiencies may be possible.

### The Necessity of Professional Advice

The advice of attorneys before and during a cooperative conversion is critical to achieving desired outcomes for the client and for the future of the cooperative business. In particular, early advice of the attorney could be crucial for the buyer and seller to understand key decision points in structuring the conversion.

Tax and securities issues are likely to be important in the cooperative conversion. If the attorney is not familiar with tax or securities law, the attorney should consult or collaborate with an attorney who is competent with those areas. The tax implications of the form of the sale of the business may vary substantially for the seller, in particular, and may in fact drive certain core matters such as whether the transfer is an asset or equity sale.

Decisions around financing of the conversion could impact liquidity, profitability, and the ability to raise future capital. Thus, these considerations impact not only the structure of the conversion but also the financial viability of the business post-conversion. Accordingly, accountants or financial advisers are also an important part of the cooperative conversion process.

### Independent Legal Advice for Each Party

There are always going to be at least two parties in a cooperative conversion, and potentially more. Below is a list of possible parties to a cooperative conversion:

* The current owners (collectively or individually), who are typically the sellers
* The workers (collectively or individually), who are typically the buyers
* The existing business entity
* A new cooperative business entity (which may be (i) a new entity or (ii) the existing business entity with certain changes to its charter documents and ownership)
* Lender(s)

Further, there may be overlap between these categories. In the case of a seller-financed conversion, the seller is also a lender. Other times, the seller may become a worker-owner after the conversion.

Each party has a lot at stake during the cooperative conversion, and it is strongly recommended that each party (or at least the buyer and seller) obtain independent legal advice. Even with more lawyers in the mix, the process can still be friendly and collaborative. The parties may then decide whose counsel will take the lead in drafting documents for the transaction. Coordination among attorneys may be managed with good communication, including the use of shared checklists or spreadsheets.

### Representing Multiple Parties in a Cooperative Conversion

Ideally, each party should have its own counsel to advise on the cooperative conversion. But in a friendly and simple conversion, the parties may seek a single attorney to get the deal done. In this situation, the attorney has the responsibility to consider what conflicts may arise, anticipate whether joint representation is reasonably possible, and advise the prospective clients accordingly. (Note: The focus of this subsection is on navigating the desire of the seller and workers to save costs through use of a single attorney in a cooperative conversion. For a discussion of representing a group of workers seeking to form a cooperative, see the section entitled, *“Navigating Conflicts While Representing Multiple Parties,”* above.)

The seller and buyer may be eager to waive conflicts for the expedience and cost-efficiency; however, substantial ethical problems may arise in this scenario. The attorney should make clients aware of the ethical limitations of a single attorney and explain that more attorneys may need to be involved. (The attorney should also explain that having an additional attorney does not mean the process will become an adversarial one.) It is important for the buyer and seller to understand the conflicts that might arise over the course of the representation. This should be done at or near the beginning of the representation so that a party may seek other counsel if needed. The engagement letter should clearly disclose the potential conflicts that may arise. (See the section entitled, *“Navigating Conflicts While Representing Multiple Parties,”* above.)

The attorney should not agree to joint representation if the conflicts are so significant that the attorney cannot provide competent and diligent representation to all clients involved.

| **→ PRACTICE TIP:***Is Joint Representation Possible?*  It is impossible for even the most experienced attorney to anticipate everything that might occur during a complicated transaction. In addition to the technical and business aspects of the deal, the attorney must try to assess whether the power dynamics between the proposed clients will make joint representation a poor tool.  In *Practicing Law in the Sharing Economy*, attorney Janelle Orsi writes that “[she is] more likely to conclude that [she] can provide competent and diligent representation to multiple clients if (1) the transaction between clients is fairly symmetrical, (2) the goals of clients are fairly aligned, and (3) the financial positions of clients are fairly similar.” Orsi says that even if there are asymmetries, joint representation could be possible if the clients have open communication between them and are willing to explore those asymmetries to work toward a balanced agreement.  It is difficult for the attorney to act as solely a “neutral scrivener” in a cooperative conversion because the transaction is a sophisticated one that likely requires heavy involvement of counsel. Often the attorney is explaining complicated documents and cannot write down the wishes of the parties without advising in some manner. Thus, the attorney should not rely on being a neutral scrivener as a way to avoid seeking informed written consent in connection with a cooperative conversion. The attorney should, in all cases, disclose the conflicts to the clients and seek informed written consent.  If the sole reason clients are seeking joint representation is to share fees, note that they may split or share fees even where they have separate counsel. For example, a seller could agree to pay or advance $5,000 in legal costs to the buyer (perhaps adding such amount to a seller-financed loan, if applicable). |
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| **→ PRACTICE TIP:** *Anticipating Conflicts of Interest Before Entering Joint Representation*  The attorney should think through possible areas of conflict prior to agreeing to joint representation. For example, the attorney planning a cooperative conversion will need to address the following critical junctures:   * Will this be an asset or entity sale? * How will the business be valued? * How will the conversion be financed? * If there is seller financing, what will be the terms of the loan? * How will the seller be involved in the future governance of the business, if at all?   Any of the above issues could cause one or more parties to seek independent counsel. Specific warning signs that joint representation is not appropriate because the stakes are too high include:   * if the worker takes a significant legal or financial risk; * if the seller plans to withdraw a substantial amount of money from the business before handing it over to the workers; * if the business has substantial existing debt and liabilities; or * if the conversion affects the employment status of the new worker-owners.   Even a point that may initially seem straightforward could become complicated enough that there should be advice from independent counsel. For example, the parties and attorney may anticipate that due diligence will be a relatively neutral and non-adversarial process. But in practice, the buyer may want a more aggressive due diligence on the business’s assets, while the seller would prefer to gloss over certain issues or keep disclosures limited.  A cooperative conversion includes many possible points of negotiation, and thus all sides could benefit from increased awareness and the opportunity for advocacy on those points by obtaining their own counsel. (Please refer to Chapter [X] for more detail on the issues that arise in cooperative conversions.) |
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### If a Client Ends Joint Representation

Once the representation has begun, it is possible that one party, having believed they would be fine in a joint representation, may realize that they want to obtain their own counsel. The party may then obtain separate counsel to discuss certain issues, draft a specific agreement, or represent them through the close of the transaction. If the party decides to end their relationship with the original attorney, then that attorney may continue to represent the remaining client(s) so long as (i) there was an advance waiver of conflicts from all clients when the joint representation began and (ii) continued representation of the remaining client is reasonably possible within the attorney’s ethical duties. The attorney must continue to protect the confidences of the client from whose representation the attorney has withdrawn.[[33]](#footnote-32)

### Advising the Worker Group

If the attorney represents a group of workers who are taking over the business, the attorney may want to seek a conflicts waiver from each individual worker in, or as an addendum to, the engagement agreement. There could be situations where one worker takes on greater risks than the others or where one worker has more to gain from the transaction. If so, that particular worker may wish to obtain separate counsel.

| **→ PRACTICE TIP:** *Representing Solely the Entity in a Conversion*  The basic principles and considerations for representing an organization (rather than its members or shareholders) are discussed at length in the section entitled, *“Conflicts of Interest,”* above. The attorney’s attention to these considerations must be heightened if they elect to represent an organization in the course of a cooperative conversion. Where a conversion is achieved through a share purchase (rather than an asset purchase), the conversion is effectuated through (very generally) some combination of the sale or redemption of the seller’s shares, amendment of the articles of incorporation, and issuance of memberships to the cooperative members. For the purposes of this discussion, key to this transformation is that there is a single entity throughout this process, and the parties on either side of the transaction are the seller and the worker group that is buying the shares. Both of these groups should be encouraged to seek independent counsel.  It is possible for the attorney to represent solely the entity throughout the process, but the attorney must remain particularly conscious of (and up-front to others about) whom they represent. A founder may technically speak for the entity at the beginning of a transaction, but by its conclusion an entirely new cooperative board may control the entity. In addition, though the attorney may and likely will be involved in organizing or negotiating the deal as a whole, their client (i.e., the entity) may not actually be a party to all of the transaction documents. For example, where a seller is selling shares directly to employees, the entity may not actually be a party to that share purchase agreement. Given all of these considerations, in many cases the best scenario is often to have independent counsel for at least the seller and the buyer. |
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# Chapter 3: Entity Choice

*Sarah Kaplan, Esq.*



## Introduction

This chapter discusses the options and decision-making process for choosing a legal entity for a worker cooperative or a multi-stakeholder cooperative with a worker-member class.

A worker cooperative is any business that is democratically owned and controlled by its workers and that primarily shares profits on the basis of patronage rather than equity ownership. Confusion about entity choice can arise because people sometimes think that a “cooperative” is one specific legal entity. There is a cooperative corporation, but not all cooperatives are organized legally as cooperative corporations. A worker-owned business could be organized as any of several different legal entities. Which entity is right for a particular business depends on a variety of factors, which will be covered in this chapter.

## Overview of the Options

In general, when several worker-owners operate a profitable business, a legal entity is needed. The California legal entities that could be used by a worker cooperative include a cooperative corporation, a limited liability company, a general corporation, and a benefit corporation. This guide focuses on the California cooperative corporation and its application to worker cooperatives. The ways in which other legal entities can be adapted for use by a worker cooperative are discussed briefly.

A threshold matter: Should you advise your client to form a legal entity at all? If two or more persons operate a business together, they may have automatically formed a partnership, and each partner could be held personally liable for obligations entered into by the other partner. If business partners want to separate the business’s obligations from their own personal assets, then it is a good time to set up a legal entity—if the owners are also ready to take on the costs of forming and maintaining the entity. Practitioners in the solidarity economy should keep in mind several common scenarios: business partners may have an exceptionally trusting relationship with each other; small-business owners may have a distrust of the state because of past and continuing state-sponsored oppression; and for some people, the minimum annual franchise tax on a legal entity is significant. For these and other reasons, forming a legal entity may not be necessary or appropriate for all worker-owned and/or operated businesses.

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## Overview of the Decision-Making Process

In the process of discussing options and recommending a legal entity for a cooperative, the practitioner will consider a constellation of factors. All the factors may lead to the same conclusion, but sometimes different factors point in different directions, and the co-op will have to compromise and choose the entity that accommodates the factor(s) that the co-op deems most important.

These are examples of questions to ask the client to draw out the factors that will likely guide decision-making:

* How many workers are there/will there be in the next few years?
* Does the co-op currently treat the workers as employees for tax purposes? Does it want to treat the workers as employees for tax purposes?
* Can the co-op afford to pay all workers minimum wage for all hours worked?
* If the co-op would be required to obtain workers’ compensation insurance, could it afford that insurance?
* Are there currently, or might there be in the future, worker-owners who do not have work authorization in the United States?
* Does this entity plan to raise capital? If so, how much, when, and from whom?
* Is this an existing business converting to a cooperative? How is this business currently organized?
* Is there some other circumstance requiring a customized solution?

The following chart may help to organize the considerations that emerge:

| IF... | THEN this indicates... |  |
| --- | --- | --- |
| IF the co-op has only a few worker-owners, and does not plan to grow quickly... | → | LLC taxed as a partnership can work, and any entity taxed as a corporation can work. Ask an accountant about tax planning. |
| IF the co-op cannot afford minimum wage, cannot afford workers’ compensation insurance, or has a small number of worker-members and does not want to deal with payroll tax or the other legal and administrative burdens of workers who are employees of the co-op... | → | LLC |
| IF worker-owner(s) are not authorized to be employed in the United States... | → | LLC |
| IF the co-op has more than about 15–20 worker-members... | → | Partnership taxation will be difficult. This indicates a corporation unless there is a specific reason to use an LLC. |
| IF the entity would benefit from being taxed as a corporation, with worker-members as W-2 employees... | → | Cooperative corporation |
| IF the entity plans to raise capital by soliciting investments of up to $1,000 per person from California residents... | → | Cooperative corporation |
| IF the entity is an existing corporation converting to a cooperative... | → | Cooperative corporation or general corporation |
| IF the entity is an existing LLC converting to a cooperative... | → | The most important factor could be the burden of transferring licenses, accounts, and contracts to a new entity. This can lead to a decision to keep the LLC. |

The cooperative corporation is meant for an organization that has members who do business with (patronize) the cooperative, who each have one vote, and who share the cooperative’s net income on the basis of patronage. In general, the cooperative corporation is a great fit for cooperatives. However, a cooperative corporation is taxed as a corporation, and the worker-members will be treated as employees for tax purposes. This could lead to a finding that the worker-members are also employees for employment law and immigration law purposes. An interest in avoiding employee classification of worker-members for employment law and/or immigration law purposes is the primary reason the cooperative corporation is undesirable or unworkable for some worker cooperatives, and these worker cooperatives tend to organize as LLCs. Some small worker cooperatives, with 2 to 10 or so members, might also choose to form an LLC because they see it as simpler.

| **“Patron” vs. “Member”**  To write legal documents for cooperatives, the practitioner needs a working understanding of the words “patron” and “member.”  “Patron” is a term of art for cooperatives. A **patron** is a person who does business with a cooperative under a pre-existing agreement to share the net income from that business “on the basis of patronage,” which means in the proportion that the person’s patronage bears to the total patronage of all patrons. “Patronage” is the business done with or for a cooperative by its patrons. Patronage can be measured by quantity, value, or some combination. In general, cooperatives can have patrons who are not members (but see Corp. Code section 12420(c), which provides that a “worker cooperative shall only make patronage distributions to the worker-member class”). If a cooperative will do the same kind of business with nonmembers as with members, the cooperative must decide whether those nonmembers will be patrons and share in patronage dividends.  A **member** is a person who has voting rights in a cooperative and/or owns equity in a cooperative. In general, the members are the patrons, and most or all patrons are members. However, cooperatives can also have “investor members” who own equity and who may or may not be patrons. Different statutes define “member” differently; for example, any equity-holder in a California cooperative corporation is a “member,” but this is not true for a California agricultural cooperative, which can only have agricultural producers as members but may have shareholders who are not members. The practitioner should be aware of these different but potentially overlapping roles. Be aware that your clients may use the word “member” to refer to “patron” and imply that investors are not members, but the practitioner must make sure that the correct word is chosen when it will have legal significance. |
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## Cooperative Corporation

### Introduction to the Cooperative Corporation

The Cooperative Corporation Law is codified in Cal. Corp. Code sections 12200 through 12704. This statute began as a legal entity for consumer cooperatives. In 2016, AB 816 added several provisions to accommodate and give some advantages to worker cooperatives. This subsection introduces certain provisions of the Cooperative Corporation Law that implement a cooperative structure for the organizations that form under that law. All code section references below are to the California Corporations Code.

A cooperative corporation can be formed for any lawful purpose, “provided that it shall be organized and shall conduct its business primarily for the mutual benefit of its members as patrons of the corporation. … Such corporations are democratically controlled and are not organized to make a profit for themselves, as such, or for their members, as such, but primarily for their members as patrons[.]”[[34]](#footnote-33) This means that worker-members benefit from the profits from their contribution of labor (their patronage), but if investors profit because of their capital investment, that investor profit is not the primary profit flow in the organization.

Corp. Code section 12253.5 provides: “‘Worker cooperative’ or ‘employment cooperative’ means a corporation formed under this part that includes a class of worker-members who are natural persons whose patronage consists of labor contributed to or other work performed for the corporation. Election to be organized as a worker cooperative or an employment cooperative does not create a presumption that workers are employees of the corporation for any purposes. At least 51 percent of the workers shall be worker-members or candidates.”

Statutory provisions support democratic member control. [Corp. Code section 12480](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12480.) provides that each member with voting power has one vote, and under section [12404](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12404.), the voting power of worker-members must be equal. Sections [12404.5](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12404.5.) and [12253(a)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12253.) require that all worker-members have the right to vote for directors (unless all worker-members govern the cooperative collectively), and that worker-member voting power must be unconditional. These provisions implement the cooperative principle of democratic member control.

[Section 12201](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12201.) gives the general guidance that the earnings of a cooperative corporation shall be “proportionately and equitably distributed to some or all of its members or its patrons, based upon their patronage.” [Section 12243(b)(2)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12243.) provides: “If the corporation is organized as a worker cooperative, ‘patronage’ may be measured by work performed, including, but not limited to, wages earned, number of hours worked, number of jobs created, or some combination of these measures.” Section 12201.5(b) requires that “patronage distributions” paid to members must be “apportioned among the members in accordance with the ratio that each member’s patronage during the period bears to total patronage by all members during the period.”[[35]](#footnote-34) Cooperative corporations are allowed to pay limited dividends on shares, but distributions on the basis of patronage are unlimited. *See* sections 12235, 12451, and 12201.

Note that the California Cooperative Corporation Law has no provision requiring patrons to have a majority of the voting power. So, it would be possible for a cooperative corporation to be controlled by nonpatron investors. Any person who possesses a proprietary interest in a cooperative is a member,[[36]](#footnote-35) and members generally have the right to vote for directors. It would be possible for a cooperative corporation to create a voting class of shares with dividends on stock and to sell that stock to so many investors that the investors could outvote worker-members. This situation, however, arguably would not comply with section 12201’s provision that cooperative corporations “are not organized to make a profit for themselves, as such, or for their members, as such, but primarily for their members as patrons.” Contrast this with the Colorado Uniform Limited Cooperative Association Act’s provision that if a cooperative formed under that law “has both patron and investor members … [t]he total voting power of all patron members must not be less than a majority of the entire voting power entitled to vote.”[[37]](#footnote-36) California’s Cooperative Corporation Law has no such provision explicitly reserving control to patron members. Because of this, practitioners should think about limiting the voting power of investor members in order to avoid any possibility of the cooperative becoming an investor-controlled business.

### Filing Requirements for Forming and Operating a Cooperative Corporation

#### Articles of Incorporation

One or more persons may form a California cooperative corporation.[[38]](#footnote-37) Article 4 of the Cooperative Corporation Law, Corps. Code sections 12310 to 12317, provides for the contents of the articles of incorporation. Certain information must be included, and certain provisions are effective only if included in the articles.[[39]](#footnote-38) [A template of articles of incorporation for a California worker cooperative corporation is available here.](https://docs.google.com/document/d/1AGrU0cTxsqgmvEKvRJgH8yZuQObusc28fiAPggqBSw4/edit?usp=sharing) This template is this author’s working version based on other templates, including [templates made available by the Sustainable Economies Law Center](https://www.co-oplaw.org/knowledge-base/california/#Model_Articles_of_Incorporation_Bylawsfor_Worker_Cooperatives_under_California8217s_new_law).

| **Practice Note: Stock or Nonstock**  California cooperative corporations can be “stock” or “nonstock” cooperatives. When you form a cooperative corporation, you can choose whether it will have shares of stock or memberships that are not represented by stock.  If you do not specify in the articles of incorporation that a cooperative is a “stock” cooperative, the Secretary of State will likely assume that it is a nonstock cooperative. If this happens, the Secretary of State will expect the cooperative to file forms, such as a Statement of Information, which, to confuse the matter, was designed for nonprofits. This can be a challenge for stock cooperatives. To clarify from the beginning that a cooperative will be a stock cooperative, include a sentence like this in the articles of incorporation:  “The proprietary interests of the corporation shall be shares of stock of the corporation.” |
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##### Signature

The California Secretary of State does not accept e-signatures or digital signatures, meaning you cannot sign a filing via an e-signature service or by typing a name. If you file by mail or in person, sign in pen. If you file by uploading a .pdf, the signature should be a scan of a signature in pen.

##### “Signed and Acknowledged”

There are two ways for the initial directors to gain the legal authority to direct a new cooperative. One is for the initial directors to be named in the articles. In this case, the initial directors have the power of directors as soon as the articles are filed with the Secretary of State. If directors are not named in the articles, the person who files the articles (“incorporator”) can appoint directors after the cooperative is formed. If directors are named in the articles, the articles of incorporation must be “signed and acknowledged” by those directors.[[40]](#footnote-39) The practitioner should look at examples successfully filed and at section 12221 to draft the acknowledgment.

##### How to File

As of the date of this writing, a California cooperative corporation cannot be formed using the Secretary of State’s Corporation Formations File Online service. You can, however, submit the articles on the Secretary of State’s website by uploading a .pdf to the eForms service. Go to <https://www.sos.ca.gov/business-programs/business-entities/forms/> and then choose “eForms.” There is no Secretary of State form for articles of incorporation of a cooperative corporation, so create your own (templates available [here](https://docs.google.com/document/d/1AGrU0cTxsqgmvEKvRJgH8yZuQObusc28fiAPggqBSw4/edit?usp=sharing) and [here](https://www.co-oplaw.org/knowledge-base/california/#Model_Articles_of_Incorporation_Bylawsfor_Worker_Cooperatives_under_California8217s_new_law)). You can also file by mail, in person, or if you are in a hurry but not in the Sacramento area, by using a service that files in person for you.

##### How to Complete the Formation

If the articles of incorporation did not name the initial directors, the incorporator should sign an “[action of the incorporator,](https://docs.google.com/document/d/1TbRm3JHWvssahBCZo-cIhmRxR1VFyd3GwxbKrDFaKGk/edit?usp=sharing)” in which the incorporator appoints at least three directors[[41]](#footnote-40) and resigns as incorporator. There is no specific time requirement to appoint directors, but the practitioner should handle this promptly to avoid leaving the client with an incomplete file.

New businesses need a tax ID number in order to open a bank account. The best way to obtain a federal Employer Identification Number (EIN) is to use the [IRS’s EIN assistant](https://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online). This assistant contains instructions on how to comply with the IRS’s requirements for third parties who obtain an EIN on behalf of a client.

##### Additional Filings and Reporting

Most California legal entities, including cooperative corporations, must file a Statement of Information within 90 days after the articles of incorporation are filed. The Statement of Information can be filed online. (See choice 3 on the menu [here](https://www.sos.ca.gov/business-programs/), or see options [here](https://www.sos.ca.gov/business-programs/business-entities/forms).) A new Statement of Information must be filed every two years.

Cooperative corporations are subject to California’s $800 minimum franchise tax. Cooperatives must file a California tax return and pay taxes to the Franchise Tax Board. See <https://www.ftb.ca.gov/file/when-to-file/due-dates-business.html> for due dates and information on how to file.

Cooperatives with more than 25 members must give their members notice each year that the members have the right to receive the cooperative’s annual financial report, and if a member so requests, the cooperative must send its most recent annual financial report to the member. Corp. Code sections 12591 to 12594 provide for the required contents of that report and other information that must be made available to members, and section 12590 provides for the required records that all cooperatives must keep.

## Limited Liability Company

### How to Structure an LLC as a Cooperative

A limited liability company (LLC) can work well for a worker cooperative when:

* being taxed as a partnership is favorable;
* the company does not plan to raise capital from “Community Investor Members” under the securities law exemption for cooperative memberships; and/or
* the cooperative will have one or more worker-owners who are not authorized to be employed in the United States.

Limited liability companies are governed by the California Revised Uniform Limited Liability Company Act, Corp. Code sections 17701.01 to 17713.13. Generally, LLC laws create a legal entity whose owners, the business partners, do business according to the terms of their agreement, as in a partnership, but an LLC provides limited liability for all business partners (“members”). The operating agreement provides the terms of the relationship among members and the company, and the operating agreement can vary statutory defaults, within certain limits.

The statutory default is that LLC members vote in proportion to their interest in current profits.[[42]](#footnote-41) The operating agreement can vary this and instead require that all members have one vote. Operating agreements may adopt consensus voting and/or specific democratic governance processes such as sociocracy or [holacracy](https://www.holacracy.org/constitution). The operating agreement could also create different classes of members with different voting rights. The LLC allows practitioners the flexibility to create the democratic governance system that fits the situation. If the LLC will be taxed as a corporation and deduct patronage dividends under subchapter T of the Internal Revenue Code, remember to comply with subchapter T’s requirements for democratic control by members.

The statutory default for allocating profit and loss among members of an LLC is in proportion to the members’ capital contributions. To use the LLC for a cooperative, the operating agreement should define “patronage” and how it is measured. Each member’s patronage will be the member’s contribution of labor or service to the cooperative, and it should be measured on the basis of quantity, value, or a combination of quantity and value. The operating agreement should provide that allocations will be on the basis of patronage.

[A sample operating agreement for a co-op LLC is available here](https://www.co-oplaw.org/knowledge-base/cartoon-operating-agreement-coop-llc/). [A shorter sample is available here.](https://docs.google.com/presentation/d/1HEILrHNgmctWHdRQgON33bfl5FbUeQPc9j1rrVY2Uyc/edit?usp=sharing)

| **Practice Note: LLCs and Subchapter T**  LLCs have more flexibility than cooperative corporations for use by social enterprises or businesses that are cooperative-like or not quite cooperatives.  One source of the legal authority for “what is a cooperative” is subchapter T of the Internal Revenue Code. Under subchapter T, corporations that “operate on a cooperative basis” can deduct patronage dividends from the corporation’s taxable income. To “operate on a cooperative basis,” the entity must be democratically governed by members who all have one vote or who vote on the basis of patronage (*see Thwaites Terrace House Owners Corp. v. Commissioner*, U.S. Tax Court, T.C.M. 406 [1996]), and the co-op must be organized primarily to benefit members, with surplus allocated on the basis of patronage. This limits the returns that a cooperative can promise to investors. Both inside and outside investment is limited. The 15% limit on dividends on stock is an example.  When the practitioner is crafting operating agreement terms to put a cooperative structure in place for an LLC, it is helpful to keep the tax treatment in mind. If an LLC will elect corporate tax treatment and wants to deduct patronage dividends, it must use one member = one vote, and it must primarily allocate surplus on the basis of patronage. If it will be treated as a partnership for tax purposes, the only “requirement” to operate as a cooperative comes from the members and their mission. |
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### Tax Considerations

The person who prepares an LLC’s tax return will have to determine each member’s interest in profits, expressed as a percentage, and allocate all items of income, gain, and loss to the members according to those percentages. The tax preparer will follow the operating agreement. In a co-op LLC, each member’s interest in profits equals the member’s patronage as a percentage of total patronage. The need to do this calculation for each member means that partnership taxation for a co-op LLC becomes more complex as the number of members increases, and this in turn means that preparing the company’s tax return and a Form K-1 for each member becomes more costly as the co-op grows. A cooperative with a larger number of members would likely choose to be taxed as a corporation for this reason alone.

In general, partnership taxation allows a company to pass losses along to members, and in certain cases, this can help members offset gains on their personal taxes. In general, being a corporation for tax purposes is better for entities that will accumulate assets. These considerations affect legal entity choice because LLCs are taxed as partnerships by default but can elect corporate taxation by filing [Form 8832 with the IRS](https://www.irs.gov/pub/irs-pdf/f8832.pdf), while cooperative corporations can be taxed only as corporations. If partnership taxation is desired, the co-op will have to form as an LLC. If corporate taxation is desired, it will likely be simpler and more advantageous to form as a cooperative corporation. It is best to consult with an accountant before choosing a legal entity so that the legal entity choice can support the tax strategy that is best for the particular business.

### Employment and Immigration Law Considerations

If there is a need to make sure that all workers are categorized as owners, and to avoid categorizing any worker as an employee for any purpose, the best practice is to organize as an LLC rather than a corporation. When a worker cooperative organizes as a cooperative corporation, all worker-members will be treated as employees for tax purposes. This could lead to the conclusion that workers are employees for other purposes, such as employment laws or immigration law. These issues are discussed further in the chapter on labor and employment law.

| **Practice Note: What If the Client Already Formed an LLC?**  Many founders form an LLC before hiring a lawyer. This is not a problem, but may require some extra legal steps. If a client simply needs to operate the LLC as a cooperative, the practitioner can help them amend their operating agreement (see 3.3.1). If corporate taxation would be better, the client can elect to be taxed as a corporation and subtract patronage dividends under subchapter T of the Internal Revenue Code. (Note that the client would elect to be taxed as a C corporation, not an S corporation, because S corporation taxation is not compatible with a cooperative’s patronage-based allocations.[[43]](#footnote-42)) If the client plans to raise capital by having investors become Community Investor Members, the practitioner should help the client convert the LLC to a worker cooperative corporation. |
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## General Corporation

The General Corporation Law[[44]](#footnote-43) contemplates corporations owned by shareholders who are not workers and who vote and receive dividends based on share ownership (capital). Nevertheless, a California general corporation can be adapted for a cooperative, as follows. The articles of incorporation may include “special qualifications of persons who may be shareholders.”[[45]](#footnote-44) Using this provision for a cooperative, the articles of an existing corporation could be amended to provide that only natural persons who regularly contribute labor to the corporation, or only natural persons who are a party to an effective employment contract with the cooperative, may be holders of the corporation’s voting stock. The articles could also include a provision that each worker-member will own one and only one share of voting common stock. In this way, a general corporation can operate on a one worker = one vote basis.

The other adjustment the practitioner will need to make to a general corporation is to cause the distributions to worker-members to be in proportion to patronage rather than share ownership. This can be done two ways. One is to have the corporation adopt a bylaw or policy that distributable net profit will be used to give pay bonuses to worker-owners, and that those pay bonuses will be in proportion to hours worked, total wages, or another measurement of the worker-owner’s patronage. Pay bonuses are wages, not patronage dividends, for tax purposes.

The other way to replace the standard per-share approach to allocations and distributions in a general corporation with a patronage-based approach is to define dividends on the worker-owners’ stock as calculated on the basis of the shareholder’s patronage. Corp. Code section 202(g)(3) allows articles of incorporation to specify the rights of different classes of stock, and this includes the dividends. Under section 109.5(a), “[p]rovisions of the articles described in paragraph (3) of subdivision (g) of Section 202 [including the rights of classes of stock] ... may be made dependent upon facts ascertainable outside the articles, if the manner in which those facts shall operate upon those provisions is clearly and expressly set forth in the articles.” The articles could state that all dividends on the specified class of stock will be in proportion to the holder’s number of hours worked during the relevant time period, for example. Note that the practitioner will need to create multiple classes of stock to use this strategy, because section 202(g)(3) applies only when there are multiple classes of stock. The distribution of the corporation’s assets upon dissolution could also be specified to be in proportion to the shareholders’ total lifetime patronage, for example.

In the case of converting an existing general corporation for use by a cooperative, it would seem more straightforward to amend the articles of incorporation to state that it is a cooperative corporation. This would cause the corporation to become a cooperative corporation, governed by the Cooperative Corporation Law (*see* Corp. Code section 911(a), allowing such conversion by articles amendment). The strategy of choosing a general corporation but changing its governing documents so that it operates on a cooperative basis may only be needed in special circumstances.

## Benefit Corporation

### About the Legal Entity Called “Benefit Corporation”

A benefit corporation is a general corporation that has a purpose of creating public benefit. A benefit corporation has the purpose of creating public benefit in general; it may also state a purpose to create a specific public benefit. Examples of the kinds of specific public benefits this law contemplates are listed in [Corp. Code section 14601(e)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=14601.). The statutory provisions about benefit corporations (a) allow corporations to have and pursue beneficial purposes without fear of shareholder backlash and (b) provide accountability for at least attempting to create the stated beneficial purpose(s).

Pursuing public benefit and any specific public benefit stated in the articles is defined as being in the best interests of the corporation.[[46]](#footnote-45) In making decisions, directors are explicitly allowed to consider “community and societal considerations,” “the local and global environment,” and “the ability of the benefit corporation to accomplish its general, and any specific, public benefit purpose,” in addition to the interests of other stakeholders and the interests of stockholders.[[47]](#footnote-46) These provisions protect directors and the corporation from shareholder lawsuits alleging that a director breached their duty to the corporation or failed to act in the corporation’s best interests, in the event that directors decide to pursue public benefit at the expense of maximizing profit.

As to accountability, benefit corporations must prepare and publish a benefit report, detailing progress creating the benefit, assessed against a third-party standard.[[48]](#footnote-47) A shareholder or director may take the benefit corporation to court in a “benefit enforcement proceeding” to address a failure to pursue public benefit or a stated specific public benefit.[[49]](#footnote-48) This is a brief and incomplete overview of benefit corporations, meant only to provide context for a discussion of their use by worker cooperatives. Those working with benefit corporations will need to read the entire part 13 of division 3 of the Corp. Code (sections 14600–14631) dealing with benefit corporations.

A benefit corporation must be a general corporation. General corporations are awkward at best for cooperatives, as described above, because unusual provisions must be used to create a one member = one vote patronage-based structure in a legal entity not meant for that structure. This author finds that it more directly serves the needs of a worker cooperative to use the Cooperative Corporation Law, which requires profits to be allocated on the basis of patronage and requires democratic control by members. California practitioners do not generally try to combine benefit corporation provisions with cooperatives. Rather, we take the view that cooperatives exist for the purpose of serving their members as patrons and that the cooperative structure is intrinsically beneficial. It is theoretically possible for a cooperative or its directors to be sued by members because of a decision that benefited the environment at the expense of maximizing profit; a member could claim that this decision was not in the cooperative’s best interests. However, those who organize cooperatives to provide for mutual benefit and the sharing of profits on the basis of patronage also tend to set a culture of benefiting society at large. For this reason and because cooperatives are democratically governed, it seems doubtful that a cooperative would need any extra legal protection in order to feel the freedom to provide public benefit through its business operations.

### B Corp Certification

Some companies advertise their benefit corporation status with a “Certified B Corporation” logo. Certification as a benefit corporation is available from B Lab Company, known as “B-Lab,” which is a charitable organization. This certification is for accountability and publicity. It is not the same thing as the legal provisions discussed above. B-Lab’s certification does require a B corp to be legally organized as a benefit corporation if the benefit corporation is available in the state where the entity is organized. It is not clear if a California cooperative corporation can obtain B corp certification because B-Lab requires that certified entities state in their articles of incorporation that they are a benefit corporation, and benefit corporations are general corporations. While this is an open question, please note that it is unlikely that a cooperative can be organized as a benefit corporation under California law, because if it is a cooperative corporation, then it is by definition not a general corporation. This author has not tried adding “benefit corporation” provisions to the articles of incorporation of a California cooperative and does not know whether (1) that would be accepted by the Secretary of State or (2) that would cause problematic ambiguity about what kind of corporation it is. Practitioners representing clients who want to form a California cooperative corporation and also get B-Lab’s certification should consider reaching out directly to B-Lab before the client makes the final decision on entity choice.

## Cooperative Federations

A cooperative federation is a cooperative whose members are cooperatives. The Cooperative Corporation Law contemplates federations of cooperatives, defining them as “central organizations.”[[50]](#footnote-49) Cooperative corporations may have legal entities as members.[[51]](#footnote-50) In a “central organization,” some or all members are cooperative corporations. In general, members of cooperatives have equal voting rights, but the instance in which unequal voting for members of the same class is allowed is for central organizations. For a central organization, members’ voting power may be based on “the number of its members’ members, the patronage of its members, or both,” provided that “[i]n no event shall any member have less than one vote.”[[52]](#footnote-51)

A federation of cooperatives that is organized primarily to benefit its members as patrons and to do business on a cooperative basis would have the same reasons to organize as a cooperative corporation as a worker cooperative, namely that the Cooperative Corporation Law provides a structure for democratic governance and sharing of surplus on the basis of patronage. A federation of cooperatives could be organized as an LLC, but the drawbacks would be greater legal fees involved in drafting a customized operating agreement. Also, taxation under subchapter T would likely be better for the member co-ops than taxation under subchapter K. A federation of cooperatives could be organized as a general corporation, but this would probably involve customized, nonstandard provisions in the organizational documents. The cooperative corporation is likely more suited to federations of cooperatives in most instances.

There is one well-known example of a federation of cooperatives organized as a cooperative corporation in California, and that is the Association of Arizmendi Cooperatives. California makes its business formation filings available online; the articles of the Association of Arizmendi Cooperatives can be viewed here: <https://businesssearch.sos.ca.gov/Document/RetrievePDF?Id=01972594-4547837>.

## Multi-stakeholder Cooperatives with Worker-Member Class

A cooperative with different classes of members that have different roles in the cooperative’s business is a multi-stakeholder cooperative. For example, a multi-stakeholder cooperative could have producers, consumers, and workers as three different membership classes.

| **Practice Note: Explore Whether Stakeholders Such as Customers Need to Be Equity Owners Before Diving into Creating a Multi-stakeholder Cooperative**  It has been this author’s experience that some cooperative start-up founders describe the cooperative they want to create as including multiple kinds of members, but this may not be what they really need. For example, a marketer and fan of hard cider wanted to build a company that would publicize small cideries and their products, and help them sell cider to more people. Their plan was to feature a cider-maker each month and help collect orders for the cider. The cider-maker would be paid based on sales, like patronage. The founder’s original conception was to form a cooperative with a small number of worker-members, the cider-makers as producer members, and possibly the customers as members. After we talked about governance, we discovered that only the founder and other workers would be decision-makers. The cider-makers would benefit from doing business with the new company, from the publicity and increased sales, but neither cider-makers nor customers would be expected to come to meetings or cast votes. Therefore, we kept it simple and formed a single-member LLC.  There are circumstances in which a cooperative and its stakeholders will benefit from including more than one kind of stakeholder as members. Examples tend to be cooperatives that have farmers as producer-members, and worker-members who distribute the food or otherwise operate the cooperative’s business. When speaking about an example of a multi-stakeholder cooperative, California practitioner [Thérèse Tuttle](http://www.cooplawgroup.com/) said that it was important to have producers and worker-members in the same cooperative because it was important to have both types of members understand each other’s businesses and make decisions internally, not at arm’s length. Another example of when a multi-stakeholder structure would be worthwhile would be to include a worker-member class in any consumer-owned cooperative, such as a food cooperative, to promote and balance the often aligned, yet sometimes opposed interests of the workers and consumers.  The “point” of this practice note is that the added time and complexity of forming a multi-stakeholder cooperative is justified in some, but not all, circumstances. The practitioner would benefit from discussing relationships with founders rather than accepting uncritically a description of a planned multi-stakeholder cooperative. |
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Multi-stakeholder cooperatives need a way to define the patronage of its different membership classes, the patronage-based allocations to its different membership classes, and the governance rights of its different membership classes. The cooperative corporation allows cooperatives to do all these things.

Corp. Code section 12243 defines “patrons” and “patronage.” Patronage can be in the form of the patron’s purchases of products or services from the cooperative, the patron’s provision of goods or services to the cooperative for marketing, or work performed for the cooperative. The cooperative’s bylaws or a board policy set a specific definition of patronage that allows the cooperative to measure the patronage of each patron, and cooperatives can define patronage to include the business of more than one type of member (provision of goods and work performed, for example). In fact, it is standard in farm cooperatives that farmers both provide crops to be marketed by the cooperative and buy farm equipment or supplies from the cooperative.

The Cooperative Corporation Law allows different classes of membership with different voting rights. In general for multi-stakeholder cooperatives, each class elects a specified number of directors. An analysis of the extent to which voting rights can be limited in a cooperative corporation is beyond the scope of this chapter, but the Cooperative Corporation Law allows membership types or classes of shares with limited voting rights, with certain protective provisions.

| **Practice Note:** A multi-stakeholder cooperative should *not* elect to be a worker cooperative, because worker cooperatives can make patronage distributions only to the worker-member class.[[53]](#footnote-52) |
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Limited liability companies and general corporations could be used for multi-stakeholder cooperatives, with special provisions in their governing documents that would set up the desired balance of voting power and the desired patronage-based allocations. For the reasons discussed above for cooperatives in general, an LLC could be used when some worker-owners may be undocumented, and a general corporation could be used when the client must keep the existing legal entity for some business reason. But neither an LLC nor a general corporation is the best fit for cooperatives in general or multi-stakeholder cooperatives in particular, and adapting an LLC or a general corporation to have a cooperative structure involves additional drafting by the attorney.

# Chapter 4: Cooperative Governance, Management, and Internal Policies

*Samuel Gray, Esq.*



## Introduction

Only in the last few hundred years has the western world shifted from being governed by kings and queens to more democratic models. The same shift, however, has not happened in the business world. Corporate culture is, in a sense, still stuck in the feudal ages. That said, there are signs that a revolution is underway. According to a 2019 report from the Democracy at Work Institute and the U.S. Federation of Worker Cooperatives, the cooperative sector is growing. Given that worker cooperatives typically offer better pay and have a higher rate of survival than traditional U.S. small businesses, one can see why.[[54]](#footnote-53)

Democracy, however, takes work. With more people involved in the decision making process, there is that much more opportunity for disagreements to arise. For that reason, and others, it is important for a cooperative to adopt clear rules for its governance. Those rules vary widely across cooperatives, but they all share one thing in common: the principle of one person, one vote. Beyond that, the possibilities are endless. This chapter is intended to outline some of the key questions member-owners will face when adopting a governance model, and it shares some best practice norms that should help member-owners and the professionals advising them through that process.

## Formation and The Governing Documents

Once a group of future worker-owners has decided which entity type they would like to use to operate their cooperative, it is time to form their business. A cooperative corporation is formed by filing their Articles of Incorporation. This document describes the high level structure and governance of the cooperative, including stating the company’s official name, its status as a cooperative, its address, and describing the voting rights of members, among other information. The bulk of the cooperative’s governance, however, is described in its bylaws. For a Cooperative Corporation, much of its governance is dictated by the California Cooperative Corporation Law, which is found in Sections 12200 through 12704 of the California Corporation Code.[[55]](#footnote-54) The bylaws will often restate much of the information from the articles of incorporation, while adding all of the other core elements of the business’s governance structure, including the core requirements set forth in the California Cooperative Law. Models for cooperatives with collective and representative governance, including model articles of incorporation and model bylaws, are available at Co-opLaw.org.[[56]](#footnote-55)

***A Note About Governance in a Cooperative Set up as an LLC***

The California Cooperative Law does not apply to LLCs that choose to operate cooperatively. For that reason, LLCs can provide additional flexibility for cooperatively-minded workers who want to integrate democracy into their business governance in novel ways. In practice, an LLC can choose to adopt an identical governance model to the one outlined in the Cooperative Corporation Law, or it may modify the requirements to meet their specific circumstances. An LLC is formed by filing Articles of Organization with the California Department of State and is governed primarily by an operating agreement. The operating agreement serves a similar purpose to corporate bylaws, providing a framework for the basic governance of the cooperative. Like a cooperative corporation, an LLC may include its high level cooperative governance requirements in its formation document. This can provide the cooperative an added layer of protection from any pressures to abandon its cooperative principles, a process often referred to as demutualization. The bulk of its governance, however, should be stated in the LLC cooperative’s operating agreement.

## Member Meetings and Board Meetings

Many new cooperatives start with all of their members on the board. For those cooperatives, the distinction between the board and the membership is just a formality, and board meetings and member meetings may largely coincide. As the cooperative grows, however, some members may find that their time is better spent on running the business of the cooperative, and the group may decide to establish a representative board. A representative board is one where some, but not all, members are elected to represent the membership as a whole on the board of directors.

While the distinction between the board and members may seem arbitrary to a cooperative where all the members are on the board, it becomes critical if and when the board becomes representative. Even for an LLC, where a formal board is not required by law, it is helpful to include language in the operating agreement distinguishing the board from the membership. Having the concept of a board baked into a cooperative LLC’s operating agreement gives that LLC a common language with more traditional cooperatives. It also creates a framework that will allow for representative governance if the LLC members ever decide to adopt that model. Nonetheless, in states where it is allowed, some cooperatives will still choose to operate without a board at all, often because the concept of a board represents the exact type of hierarchical governance that the members are trying to avoid by operating cooperatively.

While some smaller co-ops may require all members to be present in order for a member meeting to take place, it is more typical for co-ops to set a minimum number of members who must be present in order to establish quorum. Quorum is the minimum number of members necessary to make decisions at a meeting of the members. This number is often defined as a percentage and typically ranges from 50% of the members to the entire membership, often depending on the size of the cooperative. Smaller cooperatives, where all of the members are more intimately involved in all aspects of the cooperative, may opt to require higher participation for quorum. Larger cooperatives, however, may opt for a lower quorum requirement in order to keep meetings (and voting) more manageable.

### The First Meeting of the Board of Directors

The first meeting of the Board of Directors should be held as soon as is practical after the cooperative corporation has formed. At that meeting, the board should formally adopt its bylaws and appoint officers. This is an important step because there are no established voting procedures and technically no members until the bylaws are adopted. Such formalities are not legally required, however, for an LLC operating as a cooperative. Rather, the members adopt the operating agreement, which establishes election procedures and the existence of the board.

The board should keep minutes for all meetings. Meeting minutes typically should include (i) the time, date, and location of the meeting, (ii) the names of all attendees and whether they missed a substantial part of the meeting, (iii) the name of the person recording the minutes, (iv) a list of those who were absent, (v) a list of all agenda items and important matters that were discussed, (vi) if any votes were held, a description of the issue, the result, and a tally of how each person voted, and (vii) the time that the meeting was adjourned. In order to avoid any disputes, it is considered best practice to have the members who were present at the meeting sign off on the minutes to ratify them. Minutes should be stored in a safe place and made available to the members.

In additional to regular agenda items, the minutes from the first meeting of the Board of Directors will include sections (i) adopting the company’s governing documents, (ii) naming officers, (iii) noting the bank information for the company’s accounts, and (iv) stating the shares issued, who they were issued to, and the value of each share. A form sample for the minutes of the First Meeting of the Board of Directors is available in the Legal Sourcebook for California Cooperatives.[[57]](#footnote-56) By following the sample provided, the board can be sure it is taking the necessary steps to complete the initial formal establishment of their cooperative .

| **→ PRACTICE TIP:** There are plenty of apps and online cloud services that make it easier for companies to record votes and keep records that are readily available to members. For instance, many companies use Google Docs to keep minutes and other records or use programs like Asana for taking or recording votes. Many of these services are free or relatively inexpensive.  While it is unlikely that any of the initial directors will object to the adequacy of notice for the first meeting of the board, it is still good to have the directors sign a waiver of the notice requirement in advance of the meeting. This is because the governing documents, which would include formal notice requirements, are not adopted until the first meeting. A waiver protects the company from any director asserting improper notice based on statutory and common law requirements that the members may not be aware of. A model Waiver of Notice and Consent to Holding the First Meeting of the Board of Directors” is included in the Legal Sourcebook for California Cooperatives. |
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### Annual, Regular, and Special meetings of the Members

Cooperatives, by their nature, are about cooperation and democratic participation. These things require work, and member meetings are where that work is primarily done. Typically, a cooperative’s bylaws will outline three types of meetings: (i) the annual meeting, (ii) regularly scheduled meetings, and (iii) specially called meetings.

The annual meeting is the only meeting that is required by law. Section 12460(b) of the California Corporations Code, governing worker cooperatives, requires that a regular meeting of the members must be held annually. As a default, all of the cooperatives elections should be held at the annual meeting unless the cooperative has identified another method that is allowed by law. Beyond that, the cooperative can deal with any business it chooses at the annual meeting. It is common for cooperatives to choose to review their finances from the previous year and approve their books in advance of the tax filing deadline. For that reason, many cooperatives choose to have their annual meeting between the end of the previous fiscal year and the tax deadline. For many cooperatives, this will mean the meeting is held some time in late January, February, or early March. This has the added benefit of avoiding interruptions during the winter holiday season. That being said, it is common for models to provide for a default annual meeting date in December. This is fine and just a matter of what works best for the Members.

| **NOTE:** As of November 20, 2015, the California Cooperative Corporations Law was amended to exempt worker cooperatives with a collective board from the rule requiring them to hold an annual meeting of the members.[[58]](#footnote-57) |
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For some cooperatives, the annual meeting is the only meeting that is regularly scheduled. Additional meetings are not required by law but can nonetheless be useful or even necessary for the governance of the cooperative. Some cooperatives may choose to schedule additional regular meetings in advance, while others may adopt a more ad-hoc approach, holding special meetings on an as-needed basis. Bylaws differ in how they handle this. Some differentiate between regular meetings (recurring meetings in addition to the annual meeting) and special meetings (meetings that are called on an as needed basis). Other bylaws only provide for the annual meeting and special meetings. There is no right answer, and the approach will depend largely on the members' preferences and the model bylaws that they are using as a basis for their governing documents. Regardless, the cooperative may adopt rules to limit how issues may be added to the meeting agenda, and, in the case of special meetings, rules to limit how those meetings are called. For instance, many cooperatives require a member’s proposed meeting or agenda item to be seconded by another member before it is put to effect.

#### Meeting Facilitation Practices

It is well and good that cooperatives hold regular meetings and vote democratically, but it is often what happens at those meetings that ensures meaningful member participation. A poorly run meeting can result in some members feeling alienated, burnt out, or remaining silent. This can result from interpersonal dynamics as well as dynamics of power, privilege, and oppression that tend to marginalize minority voices. If the member-owners want to make their meetings better, more inclusive, and more fully democratic, they may want to consider adopting policies around meeting facilitation. Some practices that member-owners might find helpful are:

* Appointing a facilitator for meetings.
* Using community agreements whereby the group outlines its expectations and rules before a discussion occurs.
* Making sure everyone has a time to speak on each issue, and asking each member to affirmatively pass if they do not wish to speak.
* Setting an agenda in advance and keeping a list of new issues that arise so that they can be addressed at the end of a meeting or in the next meeting.

Member-owners may also want to explore more holistic self-governance systems such as holacracy or sociocracy, as these provide set structures and practices for facilitating the meeting process.

| **NOTE:** Holacracy and Sociocracy are both models for facilitating consensus-based decision making in groups of people. Rather than top-down management, sociocracy and holacracy provide a framework for groups to manage non-hierarchically. Typically, organizations using these models will be broken into groups, or “circles,” that are given responsibility over different aspects of the business. Each member in a circle is given the opportunity to speak on any issue faced by the circle. These circles then report back to higher level circles until the organization as a whole comes to an agreement on the issue at hand. The practice of holacracy grew out of the practice of sociocracy and provides a more formal framework and online support to help organizations using its model. |
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The Sustainable Economies Law Center even has its own form of self-governance which it calls SELCocracy.[[59]](#footnote-58) These kinds of facilitation models would typically be adopted as a company policy rather than incorporated into the cooperative’s articles of incorporation or bylaws (or the corresponding LLC formation and governance documents). As a general rule, a cooperative’s formal and informal policies can be thought of as “management,” whereas the processes described in its articles and bylaws (or corresponding LLC documents) can be thought of as governance. The governance is the core of what makes a cooperative democratic, but the management is what makes the cooperative *feel* inclusive and participatory for its members. Put another way, the governance is the overarching architecture. The management is what happens with the people inside that architecture on the day-to-day. It can be a helpful distinction to make for any cooperative that might be tempted to put *all* of its processes into its core governing document.

| **Facilitation Resources**  Below are additional resources lawyers can refer to when advising cooperatives about facilitation styles:   * AORTA Anti-Oppression Facilitation Resources (<http://aorta.coop/wp-content/uploads/2017/06/AO-Facilitation-Resource-Sheet.pdf>): AORTA is a cooperative that helps train businesses in cooperative governance, leadership, collective decision making, and conflict resolution with a focus on anti-oppression work. * Holacry (<https://www.holacracy.org/>): Provides descriptions of the Holacratic model as well as resources for organizations interested in training in or adopting the model. * SEEDS for Change (<https://www.seedsforchange.org.uk/shortfacilitation>): Seeds For Change is an English worker owned cooperative that provides extensive resources and training for collective organizing and consensus decision making. * Sociocracy (<https://www.sociocracyforall.org/sociocracy/>):This website provides extensive resources and offers training in the practice of sociocracy. |
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## Styles of governance (representative vs. collective board)

All of a cooperative’s governance decisions are made by the Members acting either in their capacity as members of the cooperative or as members of the board. Commonly, for new cooperatives and for smaller cooperatives (20 members or less), all of the cooperative’s members are also members of the Board. For that reason, board decisions and member decisions will be effectively indistinguishable except with regards to how they are noted in the cooperative’s minutes. As membership gets larger, however, collective governance may become more logistically difficult, and the cooperative may choose to elect a representative Board consisting of only a portion of its membership. According to the ICA Group, a leader in cooperative governance models, cooperatives with less than seven members will start with all members on the board. Once a cooperative reaches seven members, most will begin transitioning to a representative board.[[60]](#footnote-59) However, it is up to each cooperative to make this decision. There are certainly examples of larger cooperatives, such as Cheese Board Collective in Berkeley, which maintains a collective board despite its larger size (~50 workers).

The size of the cooperative, however, is not always the determining factor when it comes to whether collective or representative governance is best for the cooperative. The members may also want to consider whether there is an enthusiasm or bandwidth gap between the members with respect to participating in high level governance decisions. Sometimes members may decide for themselves that they would like to sit out on some or all of the decisions faced by the board. Maybe they are more interested in focusing on the work of the cooperative, or they are simply not interested in governance but still wish to work cooperatively. In such a case, the cooperative may decide not to include those members on the Board and opt for a representative board approach. In these situations, it may be better to limit the size of the Board to include only those members that have a desire to participate.

| **→ PRACTICE TIP:** Typically, a cooperative client will come to an attorney with an idea about what it wants its governance to look like, whether that is representative or collective. As a general rule, it is not an attorney’s role to talk clients out of one governance model or another, but they can offer guidance as to the advantages and disadvantages of each approach. Collective governance may be more ideologically appealing and ensure that all members are heard at all times, but it may result in slow decision making and burnout from members that don’t want to be involved in all of the nitty-gritty executive level issues. Likewise, representative governance may seem like a practical approach, but it may introduce unnecessary complexity and resentment in a cooperative that isn’t ready to make a meaningful distinction between the board and the membership. |
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The decision as to whether the cooperative elects for direct or representative governance may come down to differences in philosophical values. Some cooperatives see universal participation in board level decisions as part of their core mission. Workers holding this philosophy may opt towards collective governance.

| **→ PRACTICE TIP:** Some cooperatives may ask why they should have a Board if all the members are already on it. It may seem redundant. Why not skip the idea of a Board altogether and just have collective governance? The simple answer is that a corporation is required by state law to have a Board.[[61]](#footnote-60) An LLC has more flexibility and may operate without a formal Board structure built into its operating agreement, but an LLC may nonetheless find a Board structure useful for a number of reasons. Having a Board structure baked into the cooperative’s governance may provide a greater degree of flexibility. It is a fairly simple matter to amend a board’s numbers and transition a cooperative into representative governance. However, introducing the idea of a board into an operating agreement that doesn’t already contemplate that would require significant revisions and possibly a new operating agreement altogether. Additionally, some cooperatives may find it useful to allow non-members to sit on their board to advise on specific issues when the members don’t have relevant expertise. A cooperative that is entirely governed by members (without a board) could not offer such a position, though they are always free to bring in outside people to serve in less formal adviser roles. |
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## Board of Directors, Officers, etc.

### Board of Directors

Before forming their cooperative, the workers should decide who will serve on the initial board of directors. The size of boards and the officer roles required will vary from state to state. For instance, in New York, a cooperative corporation must have at least five directors. In California, the board of a corporation, including Cooperative Corporations, must have at least three members, though the corporation may set a minimum above this amount. California law does not set a maximum for the number of directors. This information must be set in the articles of incorporation and/or the bylaws (or the operating agreement if the cooperative is formed as an LLC). The members may later amend the required number of directors in accordance with the bylaws or operating agreement. The initial directors will serve until directors are elected at the first annual meeting of the members.[[62]](#footnote-61)

| **NOTE:** In practice, many small cooperatives begin with all of their members on the board. As such, the member meetings and board meetings may overlap, but the workers should be sure to distinguish in their meeting minutes whether an action is done in their capacity as members or as directors. If a cooperative does have a representative board (i.e. not all members are on the board), however, it is considered best practice to have an odd number of directors to avoid tie votes. |
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The members may decide to include minimum qualifications for directors in their bylaws or operating agreement. These might include such things as (i) the completion of certain training requirements, (ii) residency in the state where the cooperative operates, or (iii) membership in the cooperative. Such qualifications, however, are not required and some cooperatives may choose to refrain from requiring any formal qualifications, electing instead to leave it up to the vote.

### Officers

Cooperatives in California are required at minimum to have a chief executive officer (or general manager), a secretary, and a chief financial officer.[[63]](#footnote-62) Some cooperatives choose to also provide for a vice president officer position. Any number of offices may be held by the same person unless prohibited by the bylaws or articles of incorporation .[[64]](#footnote-63) The names and business or residence addresses for these officers must be reported to the Secretary of State of California within 90 days after the cooperative files its original articles of incorporation and annually thereafter.[[65]](#footnote-64) These officers generally serve the following roles:

* **Chief Executive Officer (“CEO” aka General Manager, President, or Chairperson):** In a cooperative context, the Chief Executive Officer is most commonly referred to as the President or Chairperson. They typically have the power to conduct general supervision, direction, management, and control over the business, members, and officers of the cooperative. The CEO generally presides over meetings of the members and the board. They also have signing authority for the cooperative, which may be shared with the Secretary and/or the Chief Financial Officer. As part of their general power to manage the day to day activities of the cooperative, the CEO is often in charge of hiring and firing, determining the duties and compensation of agents and employees, negotiating contracts, and acting on the cooperative’s behalf to the extent the cooperative is a shareholder or member of any other business or association. If the cooperative has chosen to have a Vice-President, they will act in the CEO/President’s place when the President is unable to do so.[[66]](#footnote-65)
* **Secretary:** The Secretary is usually given the responsibility of keeping the corporate seal and affixing it when necessary, for instance on official documents at the request of the cooperative’s bank. They retain custody of the cooperative’s records, including the company’s books, meeting minutes, and the cooperative’s governing documents. They ensure the cooperative complies with any notice requirements contained in its bylaws or imposed by law. They ensure minutes are taken at all official meetings of the members and board. They maintain a record of all current members of the cooperative. They also often have signing authority for the cooperative along with the CEO/President.[[67]](#footnote-66)
* **Chief Financial Officer (“CFO” aka Treasurer):** The CFO is responsible for overseeing all funds and securities of the cooperative. They maintain the company’s bank accounts and are in charge of the company’s deposits and disbursements, including giving receipts when necessary. The CFO maintains the company’s books and transactions and must render an account of the same in response to a duly made request. They prepare the annual financial report (or direct someone to prepare it). They facilitate duly made requests to inspect the company’s financials. They also sometimes are given signing authority for the cooperative along with the President and Secretary.[[68]](#footnote-67)

### Committees

For decisions that may require more research or expertise, or which do not require the entire Board’s input, the cooperative may adopt committees. Such committees, however, are not required. New cooperatives may find that the basic governance structure is sufficient, and it can be helpful to avoid unnecessary complications while the business is still getting established. As the cooperative grows, however, it may be faced with questions that require more focused research, or it may find that delegating certain decisions to a smaller group is useful or necessary. In such a case, the board may decide to establish some official committees (commonly called board committees) or the members may form their own committees. Member committees (also commonly called ad-hoc committees) are typically less formal in nature and deal primarily with the business of the cooperative rather than its internal functions.

Board committees may be established by the bylaws or by resolution of the board. When establishing a committee, the Board will typically adopt a charter setting forth the purpose and responsibilities of the committee in question. Common board committees include (i) management review, (ii) governance, (iii) finance, (iv) executive matters, and (v) grievance committees .

Ad-hoc committees may be formed by the membership, or a subset of the membership, and they may range in terms of their formal powers. The members are free to delegate whatever powers they might hold, provided they do so in accordance with the bylaws. Ad-hoc committees typically deal with more operational matters, such as: (i) property management, (ii) office administration, (iii) market research, and other matters that may require more specific attention, research, or expertise. While board committees often perform similar functions across all kinds of cooperatives, ad-hoc committees more typically reflect the nature of the cooperative’s business activities. For instance, a food cooperative may form a committee to establish standards for supplying their produce, whereas a housing cooperative may have a committee that is in charge of ensuring the maintenance of a community garden. Likewise, a childcare cooperative may establish a committee to develop a curriculum for a pre-kindergarten program.

| **→ PRACTICE NOTE:** In order to avoid conflicts, it is important to state very clearly a committee’s purpose, powers, and responsibilities. If a committee has the right to make a decision that would otherwise be left to the Board or Members, clearly stating that right in the committee’s charter can make all the difference in avoiding conflicts down the line. |
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## Recordkeeping

Good record keeping is essential to a well functioning cooperative. Not only do members need to keep records to comply with California laws, good records help a cooperative succeed in its core mission of workplace democracy. Important decisions need to be noted in order to be effective. Important issues and information need to be communicated and shared in order for members to make meaningful decisions. On an even more basic level, a cooperative must know who its members are, and how to reach them, before it can announce and hold a vote. Member records can become even more critical in the event of a member dispute.

The California Cooperative Corporation Law provides clear guidelines for which records must be maintained by a cooperative.[[69]](#footnote-68) Every cooperative should be aware of these requirements and establish policies ensuring that they practice good record keeping.

California Corporations Code § 12590 provides that every cooperative corporation must keep adequate records of all meeting minutes and a record of all members, including their names, addresses, class of membership, and number of membership units that they hold. These records must be kept in written form or in a form which can readily be converted to written form.[[70]](#footnote-69) As such, digital copies of corporate records would be allowed under California law so long as they can be converted into clearly legible paper form.

Good record keeping also extends to keeping adequate records of the company’s financial condition as well. California cooperatives must produce an annual financial report no later than 120 days after the close of their fiscal year. They must also annually notify their members of the members’ right to receive a copy of the same, and they must provide the report upon a member’s request. Electronic copies are explicitly allowed under the law. According to Section 12591, the report should contain the following:[[71]](#footnote-70)

(1) A balance sheet as of the end of that fiscal year and an income statement and a statement of cashflows for that fiscal year.

(2) A statement of the place where the names and addresses of the current members are located.

(3) Any information required by Section 12592, including (i) a description of any transactions with directors, officers, or other interested persons involving more than $1,000, and (ii) the circumstances of any loans, guaranties, indemnifications, or advances aggregating to more than $1,000 made during the fiscal year to any officer or director.

If the cooperative has financials that have been audited by an accountant, they must provide them. If the financials have not been reviewed by an independent accountant, then the cooperative must provide the unaudited financials with a clear statement that they have not been reviewed.[[72]](#footnote-71) All of these rules are intended to make sure that the cooperative’s members are aware of the financial condition of their business and are likewise aware of any conflicts of interest that might exist in their leadership.

All of this may sound burdensome to a new or fledgling cooperative. Mercifully, the requirements of Section 12591 do not apply to cooperatives that have 25 members or less for the entirety of the applicable fiscal year.[[73]](#footnote-72) In general, however, all businesses should maintain, at a minimum, financial records that give an accurate depiction of the company’s financial state, a list of all members and the nature of their interest in the company, the company’s formation and governance documents (certificate of incorporation, bylaws, etc.), and meeting minutes reflecting any decisions of the board and membership.

It would seem only natural that a cooperative would want to give its members notice of the results of any votes. However, in the event that they don’t, the law provides a backstop. Upon request of a member made within 60 days of a meeting of the cooperative, a cooperative must inform the member of the result of any member vote held at the meeting.[[74]](#footnote-73) Even if this wasn’t legally required, it is nonetheless critical for a cooperative to have effective methods in place to communicate key information and decisions to its members. Meaningful member participation depends on a well-informed membership.

| **→ PRACTICE TIP:** Beyond its formal governance, many established companies (cooperatives included) find it helpful to adopt company policies to help standardize management and operations throughout the company. For example, most companies include their record keeping requirements in company policies rather than in their bylaws or other high-level governance documents. Company policies may reflect legal requirements or formalized company standards, such as style guidelines or communication guidelines. Management policies like these may be unnecessary for a fledgling cooperative, but they can make life a lot easier as the cooperative grows. |
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Additionally, there are a number of situations where good record keeping will be critical to the financial success of a cooperative. For instance, good financial records will help the company obtain accurate valuations, which are critical for valuing the interest of a departing member, obtaining financing, or in the event that the business (or a division thereof) needs to be sold. Likewise, maintaining good records can help a cooperative survive and avoid damages in the event of disputes over uncompensated labor, contracts, or the status of someone’s membership.

Maintaining good records is critical to the success of a cooperative, both in terms of its mission and financially. A successful cooperative should be aware of these requirements and should adopt appropriate policies to ensure that they remain in compliance with them.

### Statutory Rights to Inspect Company Records

For many cooperatives, transparency is near to the heart of their mission. Many people become worker owners because they want to play an active part in how their company runs. In order to fulfill the role of a worker-owner, a cooperative member must have access to the company’s records. Fortunately, California law strongly protects this right.

As a general rule, any request for inspection of records will not be considered to be complied with until the records in question are provided in written form.[[75]](#footnote-74) The statutory rights of the Members to inspect the company’s records may not be restricted by the cooperative.[[76]](#footnote-75) These rights are set forth in Sections 12600 through 12608. Under these provisions, a member holding 5% or more of the voting power in the cooperative has the right to obtain records of all of the members’ names, addresses, and voting rights.[[77]](#footnote-76) The request, however, must be reasonably related to the member’s interest as a member. If a cooperative believes a member’s request is not reasonably related to their interest as a member, the cooperative may deny the request.[[78]](#footnote-77)

Members further have a statutory right to inspect the accounting books and records and minutes of proceedings of the members and the board and committees of the board, provided the member’s request is reasonably related to that person’s interest as a member.[[79]](#footnote-78) Directors additionally have an absolute right to inspect all books, records, and documents of any kind and to inspect the physical properties of the corporation of which such person is a director.[[80]](#footnote-79)

While it is important for members to have access to their business’s records, these rights can be subject to abuse. A member’s access to company records should be for appropriate business purposes. There is no obligation for the company to provide records to facilitate a member’s improper purpose, such as in the case of harassment. While any member may inspect the member list for a lawful purpose, there are some uses that are specifically prohibited without the approval of the board. These include if the membership list would be:

(1) Used to solicit money or property unless such money or property will be used solely to solicit the vote of the members in an election to be held by their corporation;  or

(2) Used for any purpose which the user does not reasonably and in good faith believe will benefit the corporation;  or

(3) Used for any commercial purpose or purpose in competition with the corporation;  or

(4) Sold to or purchased by any person.[[81]](#footnote-80)

In addition to adopting policies about record keeping, a cooperative might consider adopting policies establishing clear procedures for access to company records. This can help make sure that members know how to get the information they need, while simultaneously letting the membership know that their personal information will be adequately protected.

# Chapter 5: Cooperative Finances

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## Introduction

Entity type is elected at the state level. A for-profit company can elect common entity types like LLC or general corporation, and many states also allow for-profit companies to elect the cooperative corporation entity type. Importantly, a business can adopt a worker cooperative structure using nearly any entity type and embed cooperative principles and practices in its governing documents.

Tax status is elected both at the federal and state levels. Here we will primarily discuss federal taxation. Depending on the state, tax laws sometimes follow federal designations, and sometimes not. For example, a democratic corporation may be able to be taxed as a cooperative under federal tax law. But for state taxes, that cooperative tax election might not exist. The democratic corporation could need to file state taxes as a general corporation instead. In California, taxation of cooperative corporations mirrors federal cooperative taxation.

While the default federal taxation for a corporation is Subchapter C and the default taxation for an LLC is Subchapter K, these default tax codes might not be the right option for cooperative businesses, for a variety of reasons. A cooperative organized as a corporation or an LLC could also elect to be taxed under Subchapter T (i.e. the cooperative tax code) or Subchapter S of the Internal Revenue Code (IRC) for federal tax purposes.[[82]](#footnote-81)[[83]](#footnote-82)[[84]](#footnote-83)

The combination of entity type and tax status have implications for:

* How equity is handled in the cooperative
* Taxation of the cooperatively-structured entity
* Taxation of the cooperative’s individual members
* How profits and losses are allocated
* Redemption of member capital

Below we discuss the implications of being taxed under Subchapter T, Subchapter S, and Subchapter K and provide analysis on the advantages and challenges of each option. Generally speaking, deciding between these options will be a matter of weighing preferences for how to handle equity in a cooperative, and balancing that with each tax treatment’s subsequent tax consequences for owners. Deciding between these options requires a cooperative business to consider numerous factors, including:

* How profits are allocated
* Whether the company wants or needs the ability to retain earnings collectively
* How profits are taxed at the entity level and member level
* What flexibility they want or need for the number and type of members
* What flexibility they want or need for the number and type of classes of shares
* How they want members to be treated for tax law and employment law purposes

## Subchapter T Cooperatives

The IRS provides for a special tax treatment of co-ops in Subchapter T (“Cooperatives and Their Patrons”) of the Internal Revenue Code.  The definition of “operating on a cooperative basis” was established in a court case, *Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue, 44 T.C. 305 (1965)*. It requires that a corporation possess the following characteristics in order to qualify for Subchapter T treatment:

* Promotes the subordination of capital, with respect to control over the cooperative undertaking (i.e. power and control are not allocated based on the amount of capital invested)
* Affords democratic control by the members;
* Vests in and allocates among the members all net profits in the form of patronage.[[85]](#footnote-84)

Worker co-ops under Subchapter T include any business with the above characteristics that elects to be taxed under Subchapter T. This could include general corporations, LLCs, or cooperative corporations. Co-ops that have made this election can be called “T-Corporations.”

In order to elect to be taxed as a T-Corporation, a business must have a preexisting obligation to operate on a cooperative basis. The business informs the IRS that it’s electing to be taxed under Subchapter T when it files its annual taxes using Form 1120C, as opposed to the typical Form 1120 for a C-Corporation or 1120-S for an S-Corporation.

### Why Choose Sub T Taxation for Cooperatives?

Subchapter T often best fits the needs of employee-owned businesses because it allows for flexibility in passing on taxable patronage dividends to members, allows distributed patronage dividends to be tax deductible to the business entity, and because it allows for profit sharing based on patronage and access to a collective account.

Subchapter T allows co-ops to combine aspects of a corporation and a “pass-through” entity by having some income taxed at the corporate level and some income passed through to members. The ability Subchapter T provides to either immediately distribute or wait to distribute patronage dividends can be especially beneficial in the face of changing tax rates. Profits can be allocated to members as a means of limiting corporate taxes. By paying lower taxes, the co-op is able to put more of its earnings back into the business, which creates an opportunity to fuel growth.

Under the tax law amended through the 2017 Tax Cuts and Jobs Act, patronage dividends also became eligible for the 20% pass through business deduction. This means that only 80% of profits allocated to owners are subject to income tax.

Maintaining a collective account is also desirable for many employee-owned businesses. A healthy collective account generally means the company can position itself to grow and expand, can weather the ups-and-downs of the business cycle, and can ensure that cash is available to pay off member’s equity balances if they need to leave. Regarding growth, while many companies take on debt and outside investments to finance growth, the most sustainable and least risky way to grow is through the reinvestment of retained earnings. As the saying goes, revenue is the cheapest form of capital. To ensure a healthy collective capital account, a co-op should not commit 100% of its net income to the membership. Rather, it should split net income between the membership and the cooperative's collective account.

The allocation of net income between individual member accounts and the collective account represents a balance between what is fair for current members and what is needed to keep the business strong for the future. A business that commits most of its net income to the membership does so at the expense of its own capital base. A business that returns little of its net income to the member-owner may foster dissatisfaction. By using a system of internal capital accounts, the needs of the individual members are balanced with the needs of the business entity.

Subchapter T is an ownership model that can feel familiar to employees, versus Subchapter S and K which require quarterly estimated tax payments, a new concept for many. Under Subchapter T, worker-owners are treated as employees who receive a W-2 for regular income. They receive Form 1099-PATR for additional profits or losses allocated to them.

While treating members as employees for both tax and employment law purposes works for many cooperatives, there are some situations where co-ops might be trying to avoid employee classification of members and may find this election too restrictive.

As is mentioned above, another challenge of Subchapter T is the ambiguity of whether members are required to pay self-employment taxes on patronage dividends. Many cooperatives have been operating under Sub T and not paying any self-employment taxes on patronage dividends. Some hold dividends for a period of three years in the company before distributing, expressly to demonstrate they are not wage income, should they be questioned by the IRS. Recently, however, the IRS issued a private letter ruling stating that payroll taxes should be paid on any patronage dividends.[[86]](#footnote-85) This private letter ruling created ambiguity about self-employment taxes under Sub T. In recent tax forms the IRS has asked cooperatives to report this income and pay payroll taxes on it.

Some of this ambiguity about the tax treatment of patronage dividends under Subchapter T has to do with the fact that Subchapter T is essentially a tax code for agricultural cooperatives that worker cooperatives started using. For example, many co-ops have not paid payroll taxes on patronage dividends but this remains a legal gray area with the IRS.

### Sub T - How Worker-Member Equity is Handled in an Internal Capital Account Cooperative

Many, but not all, worker cooperatives choose to have an internal capital account system. Each worker-member has an individual capital account to keep track of their portion of the firm’s net worth and reflect the value of the member’s relative equity in the corporation. This model capital structure differs substantially from the capital structure in a conventional business corporation.

In a conventional corporation, the net worth of the company is reflected in the stock shares. If the company succeeds and retains earnings, the net worth of the company (and thus the value of the shares) increases over time. If a cooperative records its value in the price of a share, then the appreciated value of these stocks might make them too expensive for new members to purchase. Historically, use of such capital shares has led to the demise of democratic structure in a variety of employee-owned firms, most notably the plywood co-ops of the Pacific Northwest.[[87]](#footnote-86)

The internal capital account system addresses this issue by shifting the function of carrying the net worth of the company away from the shares and into the internal capital accounts. Increases in net worth will increase the balance in members' accounts, due back to them eventually in cash. The shares, however, remain at a reasonable value, enabling new members to pay an affordable membership fee when they join. At any given time, members may have differing claims on the company's equity, but they all have the same membership rights and only one membership share each. This worker cooperative structure is designed to create a business that is multigenerational in nature and sustains the democratic corporate structure over time.

Subchapter T accommodates the Internal Capital Account system, though there are co-ops taxed under Subchapter T that are not Internal Capital Account cooperatives.

An internal capital account cooperative allocates its net income in two ways: member patronage income and collective net income. The member patronage income is allocated to individual capital accounts that are designated to be paid out to the individual members as patronage dividends. As such, the individual member has a claim to the value tracked in this account, which can be paid out as cash or held in the company as equity. The collective net income on the other hand, is corporate income that is not allocated to individual members and is instead designated to be controlled by the cooperative as a whole. This collective net income is allocated to a “collective account” or “unallocated retained earnings account.” While no individual member has a claim to the value associated with this account, the collective account is still co-owned by the members and can be used to benefit them in a variety of ways, such as by issuing bonus, raising wages, or making investments that help grow the cooperative. It is just not owed to any one member when they leave the co-op.

### Sub T - Corporate Taxation

Under Subchapter T, the co-op is taxed at the corporate level and pays federal income tax on collective net income. The payment of patronage dividends is ultimately tax deductible by the T-Corporation, meaning that Subchapter T cooperatives avoid double taxation on profit allocations.

Additionally, a T-Corporation may distribute member patronage income in cash or in cash and written notices of allocation, which represent the equity held in their account. Because the member is taxed on the total value of the patronage, meaning both the cash they receive and the amounts allocated to their internal capital account as written notices of allocation, co-ops are required to pay out a minimum of 20% of the patronage dividend in cash to ensure members can pay their income tax obligation. When a co-op meets this requirement, the written notice of allocation is called a Qualified Written Notice of Allocation, and meets the IRS requirements for it to be tax deductible at the corporate level and taxable at the member level.

While not commonly used by worker co-ops, a T-Corporation can also elect to issue allocations to member’s internal capital accounts using a Non-Qualified Written Notice of Allocation, which is any Written Notice of Allocation that fails to satisfy any one of the qualification conditions- ordinarily the 20% cash payment component. T-Corporations pay tax on Non-Qualified Written Notice of Allocation and that tax is refunded when the non-qualified notice is paid out in cash. The member pays personal income taxes on nonqualified notices in the year the co-op redeems it from them for cash. The primary reason to choose Non-Qualified Written Notice of Allocation is to impact either the corporation's or a member’s taxable income. Non-Qualified Written Notices of Allocation are most frequently used in agriculture co-ops, where farmer-members often have a year where they make a profit, and the next where they don’t. By shifting between qualified and non-qualified written notices, these farms better manage their income and losses. For most Worker co-ops, however, workers will not have incomes that move between tax brackets, and so are unlikely to employ the use of non-qualified notices.

### Sub T - Member Taxation

Under Subchapter T, member-owners are treated as employees who have standard taxes withheld and who receive a W-2 for regular wages. They are also treated as recipients of patronage dividends. Each year, dividends are allocated according to each member’s contributed labor or “patronage” and these dividends are called “patronage dividends.” Members pay income tax on patronage dividends, which are reported on form 1099-PATR (as discussed in Chapter 6).

Personal tax is owed by the member both on the cash and any qualified notices of allocation received as part of a patronage dividend. When the co-op redeems the qualified notice from the member for cash in a future year, the member does not owe any additional tax.

While at first it may seem that members have to pay taxes on money that they don’t receive using qualified written notices of allocation, it’s important to remember two things. First, when members receive qualified written notices of allocation, they also receive at least 20% of their patronage dividend in cash. This allows for cash on hand to pay taxes on the qualified written notices of allocation. Second, when the value of the internal capital accounts are paid out in cash, the member receives that payment tax free. Since a member’s income should increase over time, by deferring this income, the member winds up paying less in taxes than they would otherwise pay. By retaining money in the cooperative, the business is able to invest in the firm, which should also increase the ability to raise incomes at a later date. The co-op does need to manage its money, however. Therefore great attention must be paid to the schedule on which the co-op pays out its internal capital accounts values to ensure it does not negatively impact the company’s operations.

### Sub T - Determining Profit Allocations

The profit or net income determined according to the Generally Accepted Accounting Principles (GAAP) is called the “Accounting Net Income” or “Net Income,” which is calculated as an entity’s income minus cost of goods sold, expenses, depreciation, amortization, interest, and taxes. Cooperatives typically base the patronage dividends and other internal capital account calculations on the Net Income.

Once the cooperative has calculated its Net Income for the fiscal year, it must identify the portion of the Net Income derived from business done with or for Members. This income is termed “Patronage Sourced Income”[[88]](#footnote-87) (aka “Patronage Income”), and for most worker cooperatives, is income resulting from the labor of worker owners.

The cooperative must engage in a multi-step process to first calculate its Patronage Income and then determine its patronage distributions:

1. **Step 1 - Calculate “Potential Patronage Income”**
   1. Calculate Potential Patronage Income by subtracting Ancillary Net Income from Net Income (i.e., Net Income - Ancillary Net Income = Potential Patronage Income)
      1. Ancillary Net Income is income that results from transactions that do not actually facilitate the main activity of the cooperative and do not result from Member Patronage. Common examples of Ancillary Income include interest income on long-term investments, rental income (except where the rental directly relates to the main activity of the cooperative), and gain from the sale of capital assets. Ancillary Net Income is allocated to the Collective Account.
2. **Step 2 - Determine “Member Patronage Income”** 
   1. First, calculate the “Member Patronage Ratio” using the patronage basis described in your bylaws. The patronage basis is most commonly hours worked or wages, but could also be some other formula that the co-op has determined represents labor contribution to the co-op.[[89]](#footnote-88) Member Patronage Ratio is calculated as ‘Contributions of Members’ divided by ‘Total Contributions of All Employees’. This percentage of contributions represented by members is the maximum amount of Potential Patronage Income that can be allocated to Members.
   2. Then, apply the Member Patronage Ratio to Potential Patronage Income to determine Member Patronage Income. The remainder is Non-Member Income. Subchapter T rules do not allow income generated by the labor of non-members to receive the preferential tax treatment that income generated by the labor of members receives. Thus it must be allocated to the Collective Account.
3. **Step 3 - Determine any amount of Patronage Income needed for the Collective Account**
   1. A co-op might decide that some portion of Patronage Income is required as additional reserves for business purposes and should not be allocated to any individual. Instead it may allocate that Patronage Income to the co-op’s Collective Account in addition to the Ancillary Income and Non-Member Income allocated to the Collective Account. The co-op Board of Directors is typically responsible for determining what amount of Patronage Income must be set aside for the Collective Account. However, the co-op’s governing documents may also outline specific requirements. Some co-ops choose to require a certain percentage or amount for the Collective Account. Other co-ops make the decision on an annual basis based on the financial needs of the co-op.
4. **Step 4 - Allocate Member Patronage Income as A.) Cash, or B.) Cash and Written Notices of Allocation**
   1. Determine what amount of Patronage Income is available for distributions to Members, by subtracting the amount calculated in Step 3 for the Collective Account from the amount calculated in Step 2.
   2. Of that Patronage Income available for distributions to members, the co-op must decide what amount it will pay in cash and what amount it will pay in paper, called a written notice of allocation, to a member’s internal capital account. The written notice of allocation will be redeemed by the company for cash in the future, per the rules outlined in its governing documents.
      1. Importantly, profits available for allocation are calculated based on Net Income, which is a figure that does not include all of a co-op’s cash expenses, such as principal payments on debt or annual capital expenses. Allocating too much money to individuals as cash patronage could result in the co-op not having enough money to pay its debts or make necessary investments. The co-op’s decisions about profit allocations necessitate finding the right balance of allocating profits to the Collective Account, paying cash distributions to members, and allocating profits to Individual Capital Accounts in order to keep both the co-op healthy and provide meaningful financial benefit to members.
   3. Patronage is distributed to individual members based on their individual patronage contribution. To calculate patronage for each member, calculate their individual contribution as a percentage of total member contribution and then apply that to the amount of Patronage Income available for distributions. Members pay personal income tax on any cash distributions from Member Patronage Income, as well as Qualified Written Notices of Allocation issued to them.
5. **Step 5 - Determine “Collective Net Income”**
   1. Finally, any money allocated to the Collective Account (Ancillary Income + Non- Member Income + Patronage Income Allocated to the Collective Account) is “Collective Net Income,” and the co-op pays corporate income tax on it.

| **EXAMPLE:**  **Determining Profit Allocations in a Subchapter T Cooperative**  ABC Childcare Company  Total Revenue: $1,000,000  Net Income: $100,000  Ancillary Income: $0  Employees: 10  Members: 8  Patronage basis: Hours worked per year  Total hours worked by employees: 17,720  Total hours worked by Members: 14,560  Member hour breakdown: 5 Members at 2,080 hours each, 2 Members at 1,560 hours each, 1 Member at 1,040 hours  Because the co-op did not have any ancillary income, its Potential Patronage Income is $100,000. First, ABC Child Care Company must determine the Member Patronage Ratio, by taking Member Patronage (14,560 hours) and dividing it by Total Patronage (17,720 hours). This equals 82.17%.  The co-op must then apply this ratio to its Net Income: 82.17% x $100,000 = $82,170 in Member Patronage Income.  Next, the company must decide how much of its Patronage Income is needed for the Collective Account. ABC Childcare Company knows it needs an additional $40,000 for its reserves, and so $40,000 of the $82,170 of Patronage Income will be set aside for Unallocated Retained Earnings.  The final decision that must be made by the company is how it will distribute the remaining income available for Patronage distributions ($82,170 - $40,000 = $42,170), and the breakdown of cash and paper distributions. For each member receiving patronage, the co-op must calculate their individual contribution as a percentage of total member contribution to allocate the correct patronage amount to them.   |  | **Hours Worked** | **As % of Total** | **Patronage Allocation** | | --- | --- | --- | --- | | **Member 1** | 2,080 | 14.3% | $6,024 | | **Member 2** | 2,080 | 14.3% | $6,024 | | **Member 3** | 2,080 | 14.3% | $6,024 | | **Member 4** | 2,080 | 14.3% | $6,024 | | **Member 5** | 2,080 | 14.3% | $6,024 | | **Member 6** | 1,560 | 10.7% | $4,518 | | **Member 7** | 1,560 | 10.7% | $4,518 | | **Member 8** | 1,040 | 7.1% | $3,012 | | **Total** | **14,560** |  | **$42,170** |   ABC determines that it has the cash available to pay 30% ($12,651) of profit allocations to members in cash, and will pay the remaining 70% ($29,519) in paper. Because it is paying at least 20% of the allocation in cash, the paper allocations are considered Qualified Written Notices of Allocation, meaning they’re tax deductible for the co-op and the Members pay income tax on the total amount allocated to them. |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |

### Sub T - Determining Loss Allocations

When a co-op has negative Net Income, the co-op must decide how to allocate these losses in the same way it decides to allocate its profits. Members are given negative patronage allocations in accordance with their labor patronage. If a member's internal capital account has a negative value, that does not mean that they owe the co-op money, just that their share of the book value of the company has a negative value and if they were to leave they would not receive any payout. The same thing happens to the collective account. If a business has a negative equity value that does not necessarily mean that they have a negative amount in their bank account. Rather, it means that the business’s equity has negative value on its balance sheet. Generally, a business can sustain negative equity for a period of time if it has a plan for becoming profitable and the cash needed to run operations.

### Sub T - Redemption of Member Capital Accounts

At any given time, the balance in a member’s individual capital account includes any money they’ve contributed to the cooperative (the membership share) and any profit distributions allocated to them as written notices that they have not yet received in cash. When determining its policies for paying out the balance of an individual capital account, the co-op needs to be careful to ensure it has the cash to make these payments. It is critical that a co-op’s bylaws allow the co-op to defer payments to individual members in the event that there is not enough cash to make these payments. One simple way to address this is to set a target amount to be held in the collective account, as well as a set amount of reserves to be held in cash. Alternatively, a co-op could specify that if the collective account balance falls below this level, it will delay making any cash disbursements to members until the collective account balance returns to the specified level.

Co-ops that pay some amount of patronage using written notices often establish policies for how written notices are redeemed for cash. Worker co-ops generally take one of three approaches to paying out the value in a member’s internal capital account: (1) they pay out the value in the internal account after a set number of years, (2) they pay out the value when a member leaves, or (3) they pay out members when the company can afford it and not on any set schedule. In the first option, the amount put into a members account is held for a period set by the Board or the Members. After that amount of time, the co-op pays the member the cash value of the amount credited to their account and their account balance is adjusted accordingly. In the second option, the value in the member’s capital account is retained until they terminate their membership. Under this scenario, members are usually paid out the value of their internal capital account in annual installments over time. The entire value of the account (including the membership share) is divided by the number of years the payout will occur and the member receives equal payments each year. In the third option, the co-op’s governing documents outline how the co-op makes decisions to pay out the value in a member’s internal capital account.

When a member retires or their membership is otherwise terminated, their account is closed to future profits or losses at the end of the fiscal year. The co-op pays back the member the amount of their membership share (assuming it survived any losses during the worker's membership), either as a lump sum payment or over time through a promissory note . The co-op pays out the balance of the member’s written notices, per the rules outlined in the company’s governing documents.

Some coops, especially newer ones, might choose to leave their allocation policy open ended in their bylaws. This allows the Board to have flexibility in balancing the interests of owners and the business itself.

## Subchapter S Cooperatives

A corporation or LLC (or other eligible entity) that wants to operate cooperatively can also elect to be taxed under Subchapter S of the Internal Revenue Services Code, making it an “S-Corporation.” In order to be in compliance with Subchapter S, the business must possess the following characteristics[[90]](#footnote-89):

* Have 100 or fewer shareholders
* Have just one class of stock
* Be domiciled in the United States
* Have only allowable shareholders. Shareholders must be U.S. citizens or residents and must be natural persons.

### Why Choose Sub S Taxation for a Cooperative?

The core benefit of an S-Corporation is that it effectively gives corporations the benefit of a corporation with the tax-exempt benefits of a partnership. For most taxpayers, personal income tax rates are less than corporate tax rates, so if a company can pass its tax obligations on to its shareholders, less money is spent on taxes overall. Thus, Subchapter S is typically thought to be the best structure for cooperatives seeking to maximize their tax benefits. Additionally, the taxes paid on allocations to shareholders using Subchapter S do not have the same ambiguities that were discussed in the section above related to Subchapter T. Any allocations to shareholders above a reasonable market rate for their compensation (paid as W-2) are not subject to payroll taxes.

| **NOTE FROM THE AUTHORS:** In our experience at The ICA Group, we have spoken with clients with a primary goal of minimizing tax burden. This has been a very compelling reason for them to pursue S-Corp co-ops. For them, minimizing tax burden might be a chief concern that precedes other cooperative benefits. For attorneys and other technical advisors helping their clients make choices about entity choice and taxation, it’s important to help them understand some of the other tradeoffs and challenges of Subchapter S so that the company can make a clear decision about whether these tradeoffs are workable for their situation. Accountants, business attorneys, and tax attorneys are generally quite familiar with Subchapter S, which can be helpful when hiring needed advisors. |
| --- |

Perhaps the biggest challenge for companies that elect to use Subchapter S is that they cannot retain money collectively in the company. All profits and losses must be allocated amongst members, meaning the company has less flexibility regarding how it plans for its financial future.

Some of the other most basic requirements of Subchapter S might not work for worker cooperatives. Subchapter S requires that cooperatives be no more than 100 members and allows for only one class of ownership stock. Thus Subchapter S can be prohibitive for larger cooperatives or cooperatives that would like to offer multiple classes of stock, such as a class of preferred stock. S-Corporations do not allow “nonresident aliens” to be shareholders, which can be prohibitive for cooperatives with members with mixed documentation status.

Another challenge for businesses using Subchapter S is that allocations are required to be made based on share ownership. Thus, a cooperative using Subchapter S cannot use a patronage formula to distribute profits equitably based on the labor an individual contributes to the company, and assuming each shareholder owns the same amount of shares, instead must allocate the same amount to each shareholder. This can work for cooperatives where all members work roughly the same number of hours, but can be a challenge for cooperatives where there’s more variability in member contribution of labor. However, there are several workarounds. For example, a business could create a wage structure that takes into account different labor contributions. Or the business could distribute bonus payments to workers that represent differences in labor contributions. Both of these workarounds are operating expenses that reduce the company’s profits available for distribution, which would then still be distributed equally among all shareholders.

There are also tax implications for members of a Subchapter S cooperative that are worth noting. Members receive both a W-2 and a Form K-1. Form K-1 requires them to file quarterly tax returns or face a fine.[[91]](#footnote-90) The requirement to file the additional K-1 form and estimate quarterly taxes may be viewed as burdensome to employee-owners who have not had a stake in a business before individual tax filing, but the co-op could minimize these burdens for its members by offering training and connections to appropriate accountants.

Finally, the right for membership shares to be redeemed using fair market value (FMV) can cause some complications. If a company experiences considerable growth in profitability, the share value could increase to a price that the cooperative could struggle to redeem from member owners upon their departure. One workaround that a cooperative could consider would be to have an annual recital during the member meeting to affirm that a member's equity value in the cooperative is strictly the sum of their buy-in fee and their internal capital account balance and is NOT connected to the market value of the company in any way. All of the company's members must agree to this upon joining and must confirm their agreement annually to prevent issues with departure. While this workaround can protect the company from lawsuits by members about the value of their share, it’s not a full solution to this requirement. If a member’s interest is redeemed for significantly above or below fair market value, it might be considered a second class of stock by the IRS, in violation of Subchapter S requirements.[[92]](#footnote-91)

### SubS - How Equity is Handled

An S-Corporation is a “pass-through entity” at the federal level. This means that all profits and losses are allocated (“passed through”) to individual members, who pay taxes at ordinary tax rates on them. The money allocated to individual members is owed to them, even if the corporation has not yet paid it out to them in cash. The pass-through nature of an S-Corporation means that a S-Corporation Co-op cannot have a Collective Account like a T-Corporation.

Therefore, all of an S-Corporation's equity is split between its individual members and recorded in their individual capital accounts. These capital accounts are reported on the company’s balance sheets as shareholder equity, and each shareholder’s capital account is also summarized on Schedule K-1 (Form 1120-S). A member’s individual capital account reflects their current “stock basis” in the corporation’s equity.

When a shareholder makes an initial investment in the corporation (i.e. purchases a membership share), this represents their beginning “stock basis.” The shareholder’s basis is adjusted up and down over time.The basis is increased when profits are allocated to the shareholder. The basis is decreased when losses are allocated to the shareholder or when shareholder distributions are made.

### SubS - Corporate Taxation

Generally, an S-Corporation is exempt from federal income tax other than tax on certain capital gains and passive income. It is treated the same as a partnership, in that federal taxes are not paid at the corporate level. Instead, all profits and losses are allocated to members (shareholders) who report them on their personal tax returns. This allows an S-Corporation to avoid double taxation, as profits are not taxed at the corporate level in addition to the shareholder level.

Importantly, S-Corporations are not treated equally at the state level. Some states choose to follow the federal tax requirements for S-Corporations, while other states ignore S-Corporation status and tax those companies as C Corporations. In those states, the corporation would pay state and local income taxes on its profits at the corporate level.

### SubS - Member Taxation

Under Sub-S, the taxable business income is split between two components - salary and distribution. The salary is paid to owners as wages reported on Form W-2. These wages are subject to employment taxes. An S-Corporation must pay “reasonable employee compensation” to its owners as wages. All other income is allocated to shareholders in the form of “distributions,” which are not subject to self-employment tax. Allocations to shareholders are reported on Schedule K-1.

Distributions also qualify for the 20% pass-through business deduction authorized in the 2017 Tax Cuts and Jobs Act, which essentially means that only 80% of profits allocated to owners are subject to income tax.

### Sub S - Allocating Profits and Losses

Subchapter S requires that profit allocations be made on the basis of share ownership, which means that for a co-op where each member owns an equal amount of shares, allocations would be distributed equally among all members. As a pass-through entity, all profits and losses must be allocated to individuals, who pay taxes on those allocations in the year they’re allocated.

This means individuals pay taxes on money they don’t necessarily receive, similar to taxation of Written Notices of Allocation under Subchapter T. However, under Subchapter S, there is not a 20% minimum requirement for cash distributions to cover the tax burden of profit allocations. Some companies might enact policies to address this, like providing reimbursements for tax obligations or paying out an amount in cash to cover tax obligations.

Losses can be carried forward as personal tax deductions in the future by members.

| **EXAMPLE:**  **Determining Profit Allocations in a Subchapter S Cooperative**  ABC Childcare Company  Net Income: $100,000  Ancillary Income: $0  Employees: 10  Members: 8, who each own one share  Total hours worked by employees: 17,720  Total hours worked by Members: 14,560  Member hour breakdown: 5 Members at 2080 hours each, 2 Members at 1,560 hours each, 1 Member at 1,040 hours  At the end of the year, ABC Childcare Company has $100,000 that must be distributed to its members. The company has 8 members, and even though they contribute different amounts of labor (measured by hours) to the company, they each own one share. Because profits and losses of an S-Corp must be allocated based on share ownership, the $100,000 of Net Income must be allocated to each member equally.   |  | **Hours Worked** | **As % of Total** | **Profit Allocation** | | --- | --- | --- | --- | | **Member 1** | 2,080 | 14.3% | $12,500 | | **Member 2** | 2,080 | 14.3% | $12,500 | | **Member 3** | 2,080 | 14.3% | $12,500 | | **Member 4** | 2,080 | 14.3% | $12,500 | | **Member 5** | 2,080 | 14.3% | $12,500 | | **Member 6** | 1,560 | 10.7% | $12,500 | | **Member 7** | 1,560 | 10.7% | $12,500 | | **Member 8** | 1,040 | 7.1% | $12,500 | | **Total** | **14,560** |  | **$100,000** |   Each member has $12,500 allocated to them ($100,000 divided by 8). Each member’s basis in the company increases by $12,500, and each member reports $12,500 when they file their personal income taxes. The co-op then pays out $2,000 to each member in cash (a distribution), which reduces their basis in the company by $2,000 each. |
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### SubS - Redemption of Member Capital Accounts

When a shareholder exits an S-Corporation, they have a right to a percentage of the fair market value of the company based on their share ownership. Essentially, members of an S-Corp have a legal right for their membership share to be redeemed for the fair market value of the share, which could be more than what they purchased it for.

Any amount in the repurchase price above the shareholder’s basis is treated as capital gains on their individual tax return.

## Subchapter K Cooperatives

| *Preliminary Note:* Details of this subchapter K workaround are beyond the scope of this Guide. However, to briefly touch upon it, the LLC taxed as a partnership could install another entity as one of its members, effectively creating an entity within an entity, and hold the Collective Account within that member-entity. For example, you can set up an LLC with corporate tax election as a member of the main LLC with partnership tax election, and some earnings are allocated to the “member-entity” to create a collective account that individual members don't pay taxes upon. |
| --- |

A Subchapter K cooperative is an LLC with a cooperative operating agreement that is taxed as a partnership under Subchapter K of the Internal Revenue Code. Subchapter K is the default tax election for LLCs, and is only allowed for LLCs; a corporation cannot elect to be taxed as a partnership.

An LLC with partnership tax status can be member-managed or manager-managed. In a member-managed LLC, all members participate in the decision-making process of the LLC. Each member is an agent of the LLC and has a vote in business decisions. Major business decisions, like entering into contracts or other business agreements must often be approved by a majority of members (although LLC law varies from state to state so this may not be the case in all states). In a manager-managed LLC, authority of the individual members is given the manager or managers of the company.

### Why Choose Sub K Taxation for a Cooperative?

In general, a Partnership is a very flexible entity choice. In most cases LLCs can have unlimited classes of shares and an unlimited number of members. LLCs are also highly flexible vehicles for accepting investment, the terms of each new investment can be easily tailored without reference to a class of securities—and without amending the articles. LLCs also have far less rigorous requirements for shareholder meetings and record keeping. Finally, despite not being a “corporation,” owners of an LLC retain the corporate shield against personal liability for corporate debts and liabilities.

The main reason a co-op would choose to be a partnership is to avoid employee classification of their owners. That could be because they’re a startup that can’t afford things like employment taxes and unemployment insurance, or because of the immigration status of their members. Most states do not restrict ownership of an LLC, and members may include individuals, regardless of immigration status, as well as corporations or other LLCs.[[93]](#footnote-92)

A Limited Liability Company (LLC) is a business structure allowed by state statute that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Owners of an LLC are called members (not employees). However, if its workers do not have significant ownership and control over the management of the business, they will likely be considered employees. Most states do not restrict ownership, so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single-member” LLCs, those having only one owner. Each state may use different regulations and you should check with your state if you are interested in starting a Limited Liability Company. Immigrants, regardless of legal status, and even entities based outside of the U.S. may form and own an LLC in the U.S. However, additional information or licenses may be required by your state or local jurisdiction. This section provides a general overview of LLCs. We encourage you to research the specific aspects of forming a LLC in your current jurisdiction and seek advice from an attorney familiar with local laws. For more detailed information about LLCs, we encourage you to watch our webinar about Worker Coops and LLCs and download the corresponding guide on our website:

Careful attention must be paid to ensure co-ops are in compliance with applicable employment law. Non-employees are sometimes not eligible for social safety net protections such as unemployment or workers compensation insurance. A co-op could try to save money in the short term by choosing a partnership structure, but potentially create future risk for the co-op and its members by avoiding these social safety nets.

While members of an LLC partnership cooperative are generally not considered employees for tax law purposes, there is more variability in whether members of an LLC partnership cooperative are considered employees for employment law purposes. A member-managed LLC is far more likely to have its members not be considered employees for employment law purposes. A manager-managed LLC, on the other hand, is more likely to have non-managers be treated as employees for employment law purposes.

One of the biggest challenges of a partnership is that the co-op cannot have a Collective Account, since all income and losses must be allocated to the owners. A co-op could pursue a complex workaround to this challenge by establishing a separate subsidiary corporation whose sole purpose is to retain earnings.

Like an S-Corporation, there are also tax implications for members of a Partnership that are worth noting. Members receive Form K-1 for all payments made to them. Form K-1 requires them to file quarterly tax returns or face a fine.[[94]](#footnote-93) The requirement to file the additional K-1 form and estimate quarterly taxes may be viewed as burdensome to employee-owners who have not had a stake in a business before individual tax filing, but the co-op could minimize these burdens for its members by offering training and connections to appropriate accountants.

### Sub K - Equity

Like an S-Corporation, an LLC with partnership tax status is a “pass-through entity” at the federal level. All profits and losses are allocated (“passed through”) to individual members, who pay taxes on them. The money allocated to individual members is owed to them, even if the LLC has not yet paid it out to them in cash. The pass-through nature of an LLC with partnership tax status means that a co-op cannot have a Collective Account like a T-Corporation, without a complex legal workaround.

Therefore, all of a Partnership’s equity is split between its individual members and recorded in their individual capital accounts. These capital accounts are reported on the company’s balance sheets as partner equity, and each shareholder’s capital account is also summarized on Schedule K-1 (Form 1065). A member’s individual capital account reflects their current share of the partnership’s equity.

### Sub K - Partnership Taxation

As a pass-through entity, partnerships do not pay federal taxes at the partnership level. Instead, all profits and losses are allocated to members (shareholders) who report them on their personal tax returns. This allows a Partnership to avoid double taxation, as profits are not taxed at the partnership level in addition to the member level. However, at the state level, LLCs typically have to pay state taxes.

### Sub K - Member Taxation

In an LLC partnership, members are generally not considered employees for tax purposes. (The exception would be if they chose to affirmatively classify themselves for tax and payroll purposes as a W2 employee. See Employment Law Chapter for a more detailed analysis.) Instead, for purposes of tax, members in an LLC taxed as a partnership are considered self-employed. This means that members pay self-employment and income taxes on all amounts allocated to them in the year they are allocated.

There are two types of payment to members:

1. Draws, which are “advances on profits” or “guaranteed payments.”
   1. Advances on profits are not guaranteed, and are draws taken at any time as an advance on expected profits
   2. “Guaranteed payments” are essentially a substitution for salary
2. Distributions, which are made at year-end in proportion to a member’s share of the company

The IRS treats guaranteed payments as wages, and members are required to pay self-employment taxes and make estimated tax payments on these wages. The member must pay the full amount of the employment tax, but can deduct half of that amount from their Adjusted Gross Income on their individual income tax returns. This deduction is unique to guaranteed payments, and does not apply to advances on profits or distributions. For advances on profits and distributions, members pay the full amount of the employment tax on them.[[95]](#footnote-94)

The partnership generally deducts guaranteed payments on Form 1065, line 10, as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenses. Generally, organizational and syndication expenses are not deductible by the partnership. However, a partnership can elect to deduct a portion of its organizational expenses and amortize the remaining expenses (see Business start-up and organizational costs in the [Instructions for Form 1065](https://www.irs.gov/pub/irs-pdf/i1065.pdf)). Organizational expenses (if the election is not made) and syndication expenses paid to partners must be reported on the partners' Schedules K-1 as guaranteed payments.

All payments to members (Advances on profits, guaranteed payments, and distributions) are reported on Schedule K-1 (Form 1065).

### Sub K - Profit and Loss Allocations

The default for Subchapter K is to allocate profits and losses based on the percentage of ownership, meaning allocations would be equally allocated if all members have the same percentage of ownership. When a company doesn’t allocate profits and losses based on the percentage of ownership, it can raise suspicions with the IRS that the company is shifting around allocations to avoid tax liabilities. However, it is possible to allocate profits and losses in a partnership on the basis of patronage if allocations have “substantial economic effect.”[[96]](#footnote-95)

As a pass-through entity, all profits and losses must be allocated to individuals, who pay taxes on those allocations in the year they’re allocated, just like Subchapter S.

This means individuals pay taxes on money they don’t necessarily receive, similar to taxation of Written Notices of Allocation under Subchapter T. However, under Subchapter K, there is not a 20% minimum requirement for cash distributions to cover the tax burden of profit allocations. Some companies might enact policies to address this, like paying out enough in cash to cover the member’s tax obligation.

Losses can be carried forward as personal tax deductions in the future by members.

| **EXAMPLE:**  **Determining Profit Allocations in a Subchapter K Cooperative**  ABC Childcare Company  Net Income: $100,000  Ancillary Income: $0  Employees: 10  Members: 8, who each own one membership unit  Total hours worked by employees: 17,720  Total hours worked by Members: 14,560  Member hour breakdown: 5 Members at 2080 hours each, 2 Members at 1,560 hours each, 1 Member at 1,040 hours  At the end of the year, ABC Childcare Company has $100,000 that must be distributed to its members. The company has 8 members, and even though they contribute different amounts of labor (measured by hours) to the company, they each own an equal amount of the LLC’s membership units. Because profits and losses of a Subchapter K must be allocated based on share ownership, the $100,000 of Net Income must be allocated to each member equally.   |  | **Hours Worked** | **As % of Total** | **Profit Allocation** | | --- | --- | --- | --- | | **Member 1** | 2,080 | 14.3% | $12,500 | | **Member 2** | 2,080 | 14.3% | $12,500 | | **Member 3** | 2,080 | 14.3% | $12,500 | | **Member 4** | 2,080 | 14.3% | $12,500 | | **Member 5** | 2,080 | 14.3% | $12,500 | | **Member 6** | 1,560 | 10.7% | $12,500 | | **Member 7** | 1,560 | 10.7% | $12,500 | | **Member 8** | 1,040 | 7.1% | $12,500 | | **Total** | **14,560** |  | **$100,000** |   Each member has $12,500 allocated to them ($100,000 divided by 8). Each member’s basis in the company increases by $12,500, and each member reports $12,500 when they file their personal income taxes. |
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### Sub K - Redemption of Member Capital

Under Subchapter K, the partnership must redeem a member’s capital account upon their departure from the partnership, in compliance with the rules outlined in the company’s operating agreement and membership agreement.

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## Summary Table

|  | **Pros** | **Cons** |
| --- | --- | --- |
| Sub T | Profit sharing can be split based on member patronage (i.e. hours worked or another measure of their contribution etc.)  Co-op can choose to retain profits collectively  Profit allocations made to workers are tax deductible at the corporate level | Ambiguity of whether members must pay payroll taxes on patronage allocations |
| Sub S | Members do not pay payroll taxes on profit allocations  All income is taxed at personal rates, which is slightly lower than corporate rates for most people | Profits and losses are allocated by share ownership, regardless of patronage  Passthrough entity means company cannot retain earnings collectively (without a complicated workaround)  Limits on number and type of owners  Limits on additional classes of shares  Ambiguity about how to handle member’s right to redeem shares for Fair Market Value |
| Sub K | Very little restriction on who can be a member  When structured properly, members are treated as partners, not employees,  All income is taxed at personal rates, which is slightly lower than corporate rates for most people | Profits and losses are allocated by membership unit, regardless of patronage  Passthrough entity means company cannot retain earnings collectively (without a complicated workaround) |

# Chapter 6: Income Taxation of Cooperatives and their Members

*Van Baldwin, Attorney/CPA*



## Introduction

Cooperative corporations subject to the California Cooperative Corporation Law (“Co-op Corp. Law”) are generally taxed as any other corporation under local, state, and federal tax laws. This chapter, however, focuses on income tax law and how it differs related to co-ops that distribute patronage refunds, i.e., those that may use Subchapter T of the Internal Revenue Code (IRC) and similar California Revenue and Taxation Code (RTC) §s 24404-24406 (which apply to different types of co-ops) to avoid or minimize income taxes on the patronage-related profits distributed to co-op members if certain requirements are met.

| **NOTE:** Except for corporations *not* qualified or registered to do business in California, and not doing business in California, corporate California income-related taxes are called *franchise taxes*. To minimize any confusion, California franchise taxes will be referred to here as *income taxes* (as is usually the case). |
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California tax law uses the term member to reference a person who is eligible for patronage refunds and nonmember for a person ineligible for patronage refunds. Technically, a nonmember patron may be eligible for patronage refunds under the cooperative’s bylaws and the IRC. However, such eligibility would be problematic for many reasons (e.g., tracking nonmember patrons). Here, it will be assumed that only members are receiving patronage refunds.

## Corporations

Corporations, including cooperative corporations, are distinct legal entities that file their own income tax returns and pay taxes on their taxable income, which consists of ordinary income (revenues less expenses) and possibly capital gain income (proceeds less basis) on the disposition of assets. Of course, a corporation may also have one or more types of income that are exempt from federal income taxes, such as state governmental bonds. However, in California, interest income received from all governmental bonds is taxable to corporations. The income tax rates for California are currently flat for all types of taxable income: 21% for federal and 8.84% for California. Also, a corporation may not elect to be taxed as another type of entity (e.g., a partnership).

The type of federal corporate income tax form a cooperative files depends on whether the co-op distributes patronage refunds under Subchapter T of the IRC. If the co-op is making these distributions, it files Form 1120-C within 8.5 months of the end of its tax year; otherwise it files the regular corporate Form 1120 within 3.5 months of the end of its tax year (unless it requests a five-month extension). Quarterly federal estimated income tax payments (using electronic payments) are required to avoid penalties if the total tax for the current tax year is expected to be at least $500. California requires a minimum prepayment of $800 for the first quarter, which is also the annual minimum California income tax. A California corporate return (Form 100) for a nonagricultural co-op is due by the fifteenth day of the fourth month following the end of the tax year (unless it requests a six-month extension). All for-profit corporations, including agricultural co-ops, file California Form 100 related to income taxes.

Note that a cooperative corporation is a C corporation for income tax purposes, except to the extent that it is subject to the rules of Subchapter T of the IRC. For-profit corporations file federal Form 1120 or 1120-S unless they are a co-op corporation providing for patronage refunds, in which case they file Form 1120-C.

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## Other Possible Entity Options

People initially organizing a cooperative, or possibly considering the

reorganization of an existing co-op, should consider other possible legal (or tax) structures for the activities of the organization. The most obvious choice is to form a corporation, for reasons including liability protection for the members, relatively straight-forward tax rules, and relative ease in dealing with new and departing members.

Although an organization could elect the S corporation tax status, that status essentially creates a “pass-through” entity for income tax purposes and would normally result in little or no tax advantages over a co-op distributing patronage refunds. (An S corporation represents only a tax status and is not a separate legal type of corporation.) Subchapter T would generally seem to be incompatible with Subchapter S since S corporation profits are generally allocated on the basis of relative shareholdings and not patronage. As a pass-through entity (similar to an LLC [below] but with its unique set of tax rules), S corporation status would probably only complicate the tax situation for a co-op, particularly where the membership is relatively fluid (when members regularly join and depart the co-op).

While other types of entities, e.g., a limited liability company (LLC), may be considered in the formation of a California co-op, only an organization incorporated under one of the California cooperative statutory frameworks may have the words cooperative or co-op in its name. Perhaps the most prevalent other types of co-ops are found in agriculture and housing. While Co-op Corp Law provides a generic statutory framework for co-ops of all sorts (with specific provisions related to worker co-ops), agricultural and housing co-ops are generally formed under the Food and Agricultural Code and Civil Code, respectively. Although an agricultural co-op could incorporate under Co-op Corp Law, it probably would not, given the various exemptions (e.g., tax, securities) it receives by being formed under the Food and Agricultural Code.

An entity that could sometimes resemble a cooperative is an LLC, but an LLC would almost certainly want to be taxed as a partnership under Subchapter K of the IRC (otherwise, why not incorporate?). Partnership taxation and related accounting issues are generally much more complex than C corporate taxation. A partnership return for the LLC generally “passes through” all items of income, deductions, and tax credits to the individual LLC members’ personal income tax returns. As with an S corporation, such complexity is compounded if membership is relatively fluid. An LLC does provide liability protection for its members, similar to that provided to the shareholders of a corporation.

The same situation would more or less result if the cooperative was formed as a general partnership, although the entity and its partners would have no liability protection related to its partners. Comprehensive insurance protection would be necessary, although some protection could be attained by a limited partnership (at least for the limited partners).

Another possible entity option for a cooperative is a nonprofit mutual benefit corporation, which, except for the distribution and worker cooperative provisions of Co-op Corp Law, is legally similar to a cooperative. Most significantly, a mutual benefit corporation may not distribute current profits to the members. Because of the differences, a mutual benefit corporation is probably not a real option for carrying on a business, but because it would presumably be carrying on a business to mutually benefit its members (and not the public), it would generally not be able to attain tax-exempt status. (A trade association is an obvious exception, since the IRC specifically allows tax-exempt status to such associations that otherwise meet the requirements of exempt status.)

A final possible organizational option a cooperative could consider is an unincorporated association. The potential drawbacks are significant, however. Because it is not a corporation, members do not have liability protection. Also, the statutory provisions related to an association are relatively minimal and do not provide much guidance. An unincorporated association does have an advantage in that it may choose to be taxed as a partnership, a C corporation, or presumably an S corporation. In any event, an unincorporated association would probably not be a good entity option for several reasons, including questionable short- or long-term stability.

| **NOTE:** This chapter generally assumes that a cooperative is doing business as a corporation and only in California. A co-op should seek appropriate advice related to possible or actual activities in other states. At the least, there will be registration issues and possibly other issues (e.g., taxation, securities). |
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## Patronage Refunds and Other Distributions of a Cooperative

Patronage distributions represent the return of patronage-related profits based on the relative activity (e.g., labor, purchases) of each member of the cooperative. The distribution of profits to members based on each member’s relative activity, or patronage, is a traditional and significant tenet of co-ops, although not all co-ops distribute patronage-related profits (especially where the administrative costs will not offset any potential tax savings for smaller consumer co-ops). Indeed, California Co-op Corp Law itself does not require patronage-related or other (e.g., dividends on shares) distributions of profits to be made to members or anyone else. For example, a small start-up co-op may want to retain any and all of its profits for at least several years to help finance growth.

Unless a cooperative’s articles of incorporation or bylaws provide otherwise (or in the case of insolvency), the co-op’s annual profit (the excess of revenues over costs) may be applied in one or more of three ways: retained as working capital (possibly appropriated as a reserve of current and/or prior accumulated profits), distributed on the basis of members’ individual equity-related interests (i.e., as dividends), or distributed on the basis of each member’s respective patronage with the co-op in relation to total patronage. Patronage is usually defined as the central activity of the co-op, such as hours worked, wages paid in a worker co-op, or purchases in a consumer co-op. The bylaws should provide for any reserves as part of the annual distribution provisions so that their validity is not questioned, and they should be defined and used in a way that does not substantially call into question the usual distribution of patronage refunds (for which tax-deductible refunds must have a preexisting obligation).

Cooperatives that have specifically elected to be worker co-ops under California’s Co-op Corp. Law may create an “indivisible reserve account from only non-patronage-sourced profits,” a restriction that does not apply to co-ops not making such election (see Cal. Corp. Code § 12454.5).

Note that any current profits moved to a reserve account will be taxable to the cooperative. Instead of using a reserve account (which increases income taxes), a co-op board of directors should consider issuing a smaller portion of any patronage refunds in cash, i.e., increasing the amount of shares or other capital credits that are distributed to members in lieu of cash.

| **→ PRACTICE TIP:** In a year when any mandated patronage refunds would be small, a cooperative could simply distribute all refunds in whatever equity units are normally used to distribute the noncash portion of the refunds, foregoing the reduction of taxable income and eliminating the costs of issuing checks to members**,** but still providing members with a credit to their capital accounts. |
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Under California Co-op Corp Law, distributions are technically limited to the payment or allocation of gains, profits, or dividends to a member and do not include a payment or allocation based on patronage (Cal. Corp. Code § 12235). As a practical matter, distributions will probably take the form of dividends paid on the equity units (e.g., shares) of each member. Under Co-op Corp Law, distributions are limited to 15% of contributed capital each year, but the bylaws, articles, or insolvency may limit or prohibit distributions (Cal. Corp. Code §§ 12451-12454). For purposes of this chapter, however, patronage refunds are referred to as distributions.

As with any corporation, dividends on equity-related units (i.e., shares, memberships, or other capital-related credits) are not tax-deductible to a nonagricultural co-op but are taxable to its members (this is known as corporate double taxation). Unless otherwise provided in the articles or bylaws, dividends are distributed at the discretion of the board of directors.

The bylaws may provide for the time and manner of any patronage refunds to be distributed from the patronage-related profits of a cooperative. (Again, the bylaws or some other corporate document must establish an obligation for a co-op to distribute patronage refunds if they are to be tax-deductible.) Patronage is measured by the volume and/or value of a member’s activity with the co-op. Patronage must be proportionately allocated to both members and nonmembers in the determination of the profits available for patronage refunds to members. (As a practical matter, it would generally be more difficult to identify and locate nonmembers, and a co-op would probably not want to distribute at least noncash patronage allocations to nonmembers.) The refunds may be distributed in cash, property, debt, capital credits (e.g., shares and memberships), and/or services. Of course, any refunds distributed in something other than cash raise securities issues that are beyond the scope of this chapter.

| **→ PRACTICE TIP:** Depending upon the type of co-op, number of members, and other possible factors, it may not be in the best interest of a start-up co-op for its bylaws to *mandate* the distribution of patronage refunds, at least at the outset, even if reserves may be established. Reserves can provide a false sense of security since they may be confused with cash. Reserves are not *cash* but merely an accounting “set-aside” of a portion of retained earnings, which is the mathematical difference between assets and liabilities/other capital. Reserves *do* serve to limit the amount of possible profit distributions to members (and possibly others), at least as long as the reserve is in effect. If they do not have provisions for mandatory retained patronage refunds, the bylaws may be amended at some later time to provide forrefunds when the co-op is larger, and the tax savings would more than offset the resulting additional costs (e.g., administrative, accounting, professional fees). |
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## Subchapter T of the Internal Revenue Code

Cooperatives wanting to return patronage-related profits to their members may subject themselves to Subchapter T of the IRC and similar California provisions that allow a co-op to reduce its taxable income by distributing patronage-related profits based on members’ activity with the co-op if certain requirements are met. Subchapter T is specifically related to cooperatives that distribute patronage refunds. Note that the IRC uses the term patronage dividends to refer to patronage distributions. For tax purposes, the refunds may be qualified or nonqualified. (Again, the IRC uses the term patronage dividends.) Nonqualified refunds are those that do not meet one or more of the requirements below and reduce the taxable income of a co-op only when and to the extent that cash is actually paid to the members for their patronage refunds.

| **→ PRACTICE TIP:** If a cooperative wishes to distribute patronage refunds, it should seek legal assistance to ensure that its bylaws properly provide for them, particularly if the refunds will serve to reduce its taxable income. |
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The entirety of qualified refunds, including any noncash amounts, reduce a

cooperative’s taxable income if certain requirements of Subchapter T are met, including:

1. The cooperative must have a preexisting obligation to pay patronage refunds, generally found in the co-op’s bylaws. Unlike the payment of dividends (on shares), refunds may not be discretionary if they are to be tax-deductible.
2. The total refund amount must be related to the cooperative’s current patronage-related profit, generally its revenues less its expenses. A co-op has the option to reduce the surplus available by the amount of any dividends distributed for the same tax year. (For income tax purposes, the articles of incorporation or bylaws must specifically provide that dividends will not reduce the amount available for the distribution of patronage refunds; otherwise a pro rata reduction of patronage refunds needs to be made related to nonmember patronage.) Any possible reserves of profits provided for in the bylaws, from which patronage refunds or other distributions (e.g., dividends) could not be paid, would represent fully taxable income to a co-op. Unlike the prior generic California Co-op Corp Law, there is no statutory provision for reserves; if desired they should be provided for in the bylaws, preferably at the discretion of the board of directors.
3. The amount distributed to each member must be based upon their relative patronage with the co-op, e.g., a member transacting 10% of the patronage is entitled to 10% of the refunds. (In a worker cooperative, patronage would probably be defined as wages paid, hours worked, or possibly some combination of the two.)
4. At least 20% of the refunds must be distributed in cash or by check within 8.5 months of the end of the co-op’s tax year (presumably the same as its accounting year). This less-than-100% factor allows the co-op to retain, for at least some period, assets related to its profits and provides the members with at least some cash to pay their own current income taxes on the refunds they receive.
5. Each member of the co-op must receive a qualified written notice of allocation for any noncash portion of their refund. Such notice requires the consent of the member to recognize both the cash and noncash portions of the patronage refund as taxable income subject to certain exceptions, the main one being refunds related to personal purchases. For members (e.g., of a worker co-op) receiving refunds not related to personal transactions, the amount of the allocation (in whatever form, e.g., shares) will represent taxable income to the members in addition to any cash received.

| **→ PRACTICE TIP:** Consent to include patronage refunds in a member’s income may be obtained in one of three ways: by membership through a bylaw provision (probably the most common method), a copy of which must be provided to the member; by a qualified check that indicates on its face that the member also has to recognize the noncash portion of the refund as income; or by a separate written consent to the same effect. |
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A cooperative’s patronage-related profit should be determined in accordance with bylaw provisions defining how such profit is calculated each year. Those provisions should also include how the profit is distributed or allocated. A co-op may employ one of several accepted accounting methods to determine its profits. Probably the most common choices are the use of generally accepted accounting principles (GAAP) and federal taxable income, with possible modifications to either. To help minimize at least some complexities, a cooperative should consider using its federal taxable income as the basis for determining its annual income available for the distribution of patronage refunds. A sample worksheet is attached for the calculation of patronage refunds using federal taxable income as the basis of the refunds. In any event, professional assistance should be retained if patronage provisions are desired, particularly if a co-op wants to distribute patronage refunds and reduce taxable income through the use of Subchapter T of the IRC and California tax law.

| **→ PRACTICE TIP:** A cooperative should also seek professional help in the preparation of its federal and state income tax returns, especially since there are differences between federal and California tax laws as they relate to co-ops. For example, charitable deductions are limited to 10% of taxable income after patronage refunds have been taken into account. For California purposes, however, the refunds are not taken into account, so it is much less likely that charitable contributions will be limited for California purposes. Any contributions that cannot be currently deducted are carried forward to subsequent tax years (for up to five years) for both federal and California purposes. |
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| **NOTE:** The rules and impacts of Subchapter T (including its related “Regulations”) can be relatively complex, and a cooperative should almost certainly seek professional assistance in determining or distributing patronage refunds. In addition to the major requirements list above, there are also more technical requirements, e.g., related to the notice of allocation. Again, a new co-op may want to initially have discretionary or no patronage refunds provided for its bylaws. When it appears that the tax savings would justify additional patronage-related costs (e.g., issuing checks to members)—the patronage refunds requirement of the word may could be amended to *shall*, i.e.—a change of only one word would be required. In any event, a co-op could always minimize patronage-related costs by simply issuing all refunds to members in some non-cash format; of course, any current deduction for patronage refunds would be lost. |
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Some cooperatives distribute nonqualified patronage refunds. Under this scenario, the refunds are tax-deductible only when cash is actually distributed. While this option may be considered by some co-ops, there is at least some danger that a co-op could become substantially behind in paying accumulating refunds as it continually finds better uses for its cash. On the other hand, the members do not pay income taxes on the nonqualifying refunds until they actually receive cash amounts.

## Taxation of Co-op Members

Cooperative members are subject to income taxes on any profits and other income (e.g., interest) they receive from their co-op. Of course, to the extent that they are employees of their co-op, they will also be subject to federal Social Security and Medicare taxes. For California, employee-members will also pay state disability insurance taxes, in addition to California income taxes. The income subject to taxes is reported on federal forms W-2, 1099-DIV, 1099-INT, 1099-PATR, 1099-MISC, and possibly others.

Form W-2 reports any employment income and related taxes; 1099-DIV reports dividends paid to members related to any equity units (e.g., shares) they own; 1099-INT reports any interest owed to members on any debt-related instruments they hold; 1099-PATR reports any taxable patronage refunds; and 1099-MISC generally reports taxable income that is not included in the foregoing reporting forms.

Form PATR is specifically related to cooperatives that distribute patronage refunds. For nonagricultural co-ops, the form is mainly used to report the total amount of patronage refunds (including noncash amounts) to each member. Related to worker co-ops, the form will not report any amount for the relatively new 20% federal qualified business income deduction (QBI) since that deduction must be determined by the individual worker in preparing their personal income tax return. Consumer co-ops having at least 85% of their gross receipts related to retail sales for personal (nonbusiness) use may request an exemption from filing Form 1099-PATR by filing Form 3491 with the IRC. (There is no comparable California exemption.) To be clear, to the extent a consumer co-op member makes purchases for their personal (noncommercial) use, they are not liable for income taxes on any related patronage refunds.

Form 1099-PATR is required to be issued to both the member and the Internal Revenue Service by February 1 and March 1, respectively, for patronage refunds distributed in the immediate prior calendar year if the refunds exceed $10. While California’s threshold is $100, probably virtually all cooperatives issuing Form 1099-PATR will provide them to all members receiving refunds.

| **→ PRACTICE TIP:** A worker cooperative should generally try to distribute patronage refunds so that its members are taxed for only one year of such refunds and not two. This is especially the case when the co-op operates on a fiscal year different from the calendar year. A worker reports patronage-related income in the year in which they *actually* receive cash or a notice of allocation for qualified refunds. Depending upon the timing of the cash payments or notifications, a worker could receive *two* years of taxable refunds in a single year, possibly pushing the worker into higher federal and state income tax brackets. |
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Related specifically to worker co-op members, each worker should consult with their own tax preparer/adviser as to how to report the patronage refunds on their personal income tax return. Any related QBI deduction is first shown on the worker’s federal Form 8995, a part of the worker’s personal federal income tax return. It should be noted that although it appears that worker co-op members are generally eligible for the deduction, it is possible that the IRS could challenge this position. (There is no comparable California deduction.)

A tax issue that occasionally presents itself related to worker cooperatives is a possible IRS assessment of self-employment taxes on workers’ patronage refunds. Perhaps the most important consideration related to this issue is whether the worker co-op’s members are otherwise receiving reasonable W-2 compensation from the co-op. The more reasonable the compensation, the less likely the IRS will prevail since employment taxes are being paid by the co-op and the worker on that compensation. Still, this is an unsettled area of tax law; hopefully, it will be eventually settled with a legislative solution.

It is the author’s understanding that the IRS has even looked at the possibility of assessing regular payroll taxes at the corporate level on the amount of patronage refunds distributed, with the rationale being that the refunds are simply additional compensation. The reasonable compensation argument (per above) would almost certainly be relevant in this context as well.

## Income Tax Credits

There are numerous federal and California tax credits available to businesses, and sometimes available credits are easily overlooked since they are not part of a cooperative’s regular tax deductions. While a deduction reduces taxable income, a credit is a direct reduction to the relevant tax itself. There are dozens of federal tax credits that come under the umbrella category of the general business credit. Each credit has its own filing form, generally filed with the co-op’s corporate income tax form.

The current federal tax credits probably most relevant to co-ops (with the specific federal form number noted parenthetically) are as follows: employer-provided childcare services (8882), paid family and medical leave (8994), pension plan start-up costs (8881), disabled access (8826), and empowerment zone employment (8844).

Probably the most significant California credit currently available to businesses (including cooperative corporations) is the new employment credit available for certain geographical areas of the state. The credit is currently available through 2025 and may be claimed by most types of employers for each full-time qualified employee. Credits of up to $56,000 over a five-year period may be claimed for each such employee. An employer must make a tentative credit reservation, which is done online at the Franchise Tax Board website.

## Basic Accounting Issues for Corporate Income Tax Returns

When preparing their first federal (Form 1120 or 1120-C) and California (Form 100) income tax returns, cooperatives must choose their tax year and accounting method. Especially for smaller co-ops, choosing the calendar year as their tax year is usually best since payroll tax returns and many other types of returns, expenses, etc., are based on a calendar year. To avoid unnecessary complications and confusion, the accounting method for the books should be as consistent as possible with that used for the tax returns.

The principal two accounting methods are the accrual and cash methods, and cooperatives should generally choose one or the other. Under the accrual method, income is recognized when earned and expenses are deducted when incurred. The accrual method (with possible modifications) is generally required for a business that maintains inventories to be resold or to become part of products to be sold. (Related to inventories, a co-op should seek competent accounting advice as to which items should be counted as well as the method of valuation.) The accrual accounting method is more complex than the cash method (below), but its resulting balance sheets provide invaluable snapshots as to the financial position of a business. Even businesses that could use the cash method below might want to use the accrual method to generate more complete financial information. In some situations, a third-party (e.g., a lender) may require the generation of accrual basis financial statements so that it may better evaluate the performance of the borrower.

The simpler cash method generally recognizes income and expenses as cash is received and disbursed, respectively. Thus, amounts owed to the organization and owed by the organization do not have to be tallied to determine the net income/loss at any given time. Major exceptions include the acquisition of long-lived assets and their related amortization over some number of years. The cash method generally works well enough in the context of an organization providing services. Again, however, the financial information provided by the cash method is less complete and should probably be used only by smaller services organizations.

Cooperatives distributing patronage distributions should almost certainly use the accrual method (as opposed to the cash method), especially since the cash method is subject to manipulation as to the timing of cash receipts and disbursements. And particularly for co-ops having inventories for resale, the accrual accounting method is more or less required related to those inventories. As a practical matter, if the accrual method is used for inventories, it should probably also be used for overhead and other expenses (as opposed to a hybrid method).

| **NOTE:** For cooperatives with at least 26 members at any time during its accounting year, the California Cooperative Corporation Law requires that it produces an annual report to include at least the following: a balance sheet, an income statement, and a statement of cash flows. (See Cal. Corp. Code § 12591 for details.) Because there are various types of special-purpose accounting frameworks in addition to the accrual basis (which represents generally accepted accounting principles, or GAAP), it appears that § 12591 does not necessarily require the use of the accrual basis of accounting. |
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| **→ PRACTICE TIP:** Various IRS publications provide valuable information to businesses. One in particular is Publication 334, the Tax Guide for Small Business, which covers a wide range of topics, including books and records, accounting periods and methods, depreciation, property dispositions, and tax credits. While Publication 334 provides good general information, other IRS publications provide specific and detailed information related to specific tax topics. For example, Publication 542 deals specifically with corporate taxation. IRS publications should not be a substitute, however, for professional tax advice. |
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# Chapter 7: Securities / Capital Raising

*Kim Arnone and Sarah Kaplan*



## **Introduction**

Cooperatives, like all organizations, need capital to fund start-up operations or growth. This chapter focuses on obtaining capital directly from individuals, including members and nonmembers. Investments from individuals (or mission-aligned enterprises like foundations) are often the first few layers in the “capital stack.” Cooperatives often seek loans from institutional lenders such as credit unions, community development financial institutions (CDFIs), or banks after receiving some start-up funding from individual investments. Cooperatives can employ a variety of strategies to raise capital broadly and, in some cases, publicly from their members and community of supporters. Each strategy has benefits and challenges depending on the amount of capital to be raised, types of potential investors (accredited or nonaccredited), and where potential investors are located, among other factors. This chapter will outline many of the available strategies.

In addition to deciding on a legal strategy to fit capital-raise goals, a cooperative seeking investors will have to decide what type of security to offer. What can a cooperative offer to investors? This is a frequently asked question and is discussed in the section called [“What Can Co-ops Offer to Raise Capital?”](#_mwjcrczdcs01)

Any enterprise raising capital needs to prepare for the campaign from a marketing or outreach standpoint. To have a successful capital raise, an enterprise must have a compelling story connecting its vision and mission to the impact it is creating or will create with the proceeds of the capital raise. This necessarily means that the entity’s structure and business plan must be solid so that the strength of the enterprise can show in its offering materials. The enterprise must also have its financial statements in good order and in accord with the requirements of the chosen securities law strategy. Finally, and most important, the enterprise must have a target set of potential investors—usually members, customers, partners, or those who share an affinity to the mission of the enterprise.

The cooperative also needs ways to reach those investors with the offering’s disclosures, marketing materials, and impact message, especially if a broad-based public offering strategy is employed. If a public raise strategy is used, this outreach can take many forms including being able to engage with a wide range of existing customers on a regular basis, having a strong and active social media following, using an email or newsletter list, and/or having a network of supporters that will use their own connections and network to support the raise. Simply having a network or access to a network of potential investors by itself is not enough. A thoughtful and well-crafted engagement approach, whether public or private, is essential for a successful capital raise, and time should be spent to map out the campaign in advance of starting to raise capital. While the legal aspects of preparing for a capital campaign are important, no campaign can be successful without having a strong business and marketing plan.

Below we discuss the decisions that practitioners will need to help their cooperative clients make in order to prepare a compliant securities offering. We will discuss the various kinds of securities that cooperatives may offer, including types of member investments and investments from nonmembers. We will also identify the most widely used regulatory approaches for these offerings, which include private offerings and offerings allowing for general solicitation of nonaccredited investors.

## What Can Co-ops Offer to Raise Capital?

Cooperatives need capital just like any enterprise, but the cooperative form limits how co-ops can structure investments. A cooperative must be organized primarily to benefit members as patrons; if the organization primarily directs profits to investors based on their capital contributions, then it is not a cooperative. This concept is part of the cooperative principles. It is also formalized in law in a few ways. Subchapter T of the Internal Revenue Code[[97]](#footnote-96) provides a tax advantage for “any corporation operating on a cooperative basis”[[98]](#footnote-97) (with some exclusions). Case law interpreting subchapter T tells us that “operating on a cooperative basis” means that the entity is organized and operating primarily for the benefit of members as patrons, not primarily to direct profits to shareholders. Also, state and federal laws limit the dividend on stock that certain kinds of co-ops can pay. For example, a cooperative formed under the California Cooperative Corporation Law[[99]](#footnote-98) cannot pay a dividend on stock greater than 15% of contributed capital per year.[[100]](#footnote-99)

With these limitations in mind, what are typical options for cooperatives to raise capital?

### Memberships

Cooperatives can raise some capital by simply setting a price for its patron memberships. Most cooperatives don’t use the membership contribution to raise significant capital, preferring to keep membership options as accessible as possible, but it is one way to gain some start-up capital.

### Member loans

When there are members who have money available to invest, cooperatives take loans from members. Often, promissory notes from members are structured to be “patient capital,” with reasonable interest rates that are lower than the rates charged by commercial or alternative lenders. Promissory notes from members often include other favorable terms that work with the growth plan of the cooperative, such as repayment timing that accommodates the cooperative’s start-up plan.

### Nonmember loans

Cooperatives may also raise capital by offering investment notes to their community of supporters. Again, many cooperatives seek loans from supporters with the hope of lower interest rates and other more favorable terms than those offered by banks and other traditional lenders. Private offerings of promissory notes to a small number of investors often fit within a California state law exemption so that onerous filings would not be required. However, broader or public offerings of notes to nonmembers do not usually fit within exemptions to registration requirements, making offerings of notes or other securities to nonmembers more onerous. See the section below on [“Outside” Equity](#_wku22ucipa51) and the chart below in the section on [Registration and Exemptions](#_krohl41houxc) for potential offering strategies.

### Preferred shares/nonvoting shares

In addition to memberships, cooperatives can, if their formation documents allow, offer investment in the form of preferred shares of stock. In the case of cooperatives, preferred shares would have minimal or no voting rights with the control of the cooperative resting primarily with the patron members. Investors in preferred shares would typically receive dividend distributions on their ownership shares (see more detail below). Dividends can be guaranteed on an annual basis, or dividends may be due to shareholders only as declared by the Board of the cooperative. There are a variety of ways to specify what the amount of dividends will be, including a fixed percentage of the investment amount, an amount based on a revenue calculation, or simply the amount determined by the Board (within legal limits). Both patron members and nonpatrons can purchase preferred shares. Usually, with an offering of shares, the investment documents include a repurchase option so that, at some future date, the cooperative can buy back its shares and relieve itself of the dividend obligations and/or investors can request a repurchase to obtain their original investment back. The shares can be offered privately or publicly. Both public and private offerings to supporters would, of course, need to comply with securities laws to utilize an exemption and/or registration process for the offering. This is discussed in more depth below in the section called [“Outside” Equity](#_wku22ucipa51).

### Revenue-based securities

Another option for raising capital is an offering of revenue-based securities. In this approach, instead of offering a fixed interest rate or fixed dividend rate, the cooperative would offer a return based on how much the enterprise is growing its revenues. For example, a cooperative might offer to pay investors 5% of its gross revenue each year (with each investor sharing that 5% pro rata based on the amount invested), until the investors realize an agreed-upon return on their original investment amount. With revenue share securities, repayment is capped at a particular return, such as 1.2, 1.3, or 1.5 times the original investment amount. If a revenue share investment is a debt instrument, then each payment to investors is part principal and part interest so that once the agreed total payback amount is reached (however long it takes), the original debt is extinguished. If the revenue share investment is structured as a stock purchase, then once the agreed total payback amount is reached, the original shares are deemed to have been repurchased by the cooperative (each payment can be structured as both a dividend distribution and a partial repurchase of shares). The faster revenue grows, the more quickly an investor realizes their return and the better the rate of return is. The drawback of revenue share securities is that the cooperative may need the services of an accountant who can make sure the record-keeping and repayment of investors complies with treasury regulations. This means that using a revenue-based security may cause the cooperative to incur more professional service fees. The advantage of revenue share securities is that repayment to investors based on revenue sharing allows payments to be lower in start-up or low-revenue years, and allows the investor to realize some additional upside potential if high growth is reached. As with other offering options, these securities would need to fit within one or more exemptions or be registered.

## Brief Introduction to Securities Law for California Cooperatives

When an organization invites someone to contribute money in order to raise capital for the organization, and if that money is not a gift, the organization may be planning to offer a “security,” and the organization should obtain legal advice about whether and how securities laws will apply.

To greatly simplify, a security is any investment arrangement in which an investor contributes money in order to capitalize a new enterprise or contributes money with the expectation of receiving a return on that investment. Usually, the investor is passive and relies on others to manage the enterprise. Shares of stock are a common example of a security, but securities come in many forms.

To answer the foundational question of whether securities laws apply, the practitioner will need to determine whether the client is proposing to offer a security. Both federal and state securities laws may be relevant, so this question may need to be answered for both federal law and state law purposes. If a cooperative does plan to raise capital by selling securities, it must comply with state and federal securities laws, which require offerings to be registered if not exempt. Look to the law of every state where a prospective investor resides.[[101]](#footnote-100) Exemptions and registration are discussed below.

### What Is a Security? (Federal Law)

The [Securities Act of 1933](https://www.govinfo.gov/content/pkg/COMPS-1884/pdf/COMPS-1884.pdf)[[102]](#footnote-101) governs securities law issues at the U.S. federal level. This law is enforced by the [Securities and Exchange Commission](http://sec.gov) (SEC), which promulgates regulations and provides guidance.[[103]](#footnote-102) The Securities Act of 1933 defines “security” as:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘‘security’’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[[104]](#footnote-103)

The foundational case that frames our understanding of whether an economic relationship is a security is [*SEC v. WJ Howey Co.*, 328 U.S. 293 (1946)](https://scholar.google.com/scholar_case?case=12975052269830471754&q=howey+&hl=en&as_sdt=4,60). In this case, W.J. Howey Company and an affiliate sold to investors interests representing plots of land in a citrus orchard in Florida, along with a service contract to harvest and sell the citrus fruit. The investors played no part in managing or operating the business.

[“Oranges, Prospect Park, Redlands, CA 2-2012”](https://www.flickr.com/photos/23155134@N06/6841887747) by [inkknife\_2000 (11 million views)](https://www.flickr.com/photos/23155134@N06) is licensed under [CC BY-SA 2.0.](https://ccsearch.creativecommons.org/photos/null?ref=ccsearch&atype=rich)

The U.S. Supreme Court held that the term “investment contract” (emphasized above) includes “a contract, transaction or scheme whereby a person invests [their] money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party[.]”[[105]](#footnote-104) The Ninth Circuit Court of Appeals has “further held that it would not confine the Howey test to situations in which the term ‘solely derived’ applied literally, but would find the third element satisfied when ‘the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.’”[[106]](#footnote-105) The “Howey test” is still the usual starting point in an analysis of whether a proposed economic arrangement would be a security for federal law purposes.

For cooperatives, the next step in the analysis for federal law purposes would be to distinguish between (1) memberships offered to members who plan to benefit from the cooperative’s services, and (2) equity interests or debt offered to investors for investment purposes. In [*United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975)](https://scholar.google.com/scholar_case?case=11168754825085710379&q=howey+&hl=en&as_sdt=4,60), at issue were shares of stock in a housing cooperative. Co-op City, a massive housing cooperative in New York City, sold shares of stock in a nonprofit corporation. People who bought this stock were entitled to live in the housing units in Co-op City. The shareholders had to pay rent. When they left, the co-op returned the original purchase price of the share, but the shares were not dividend bearing and did not increase in price. The court held that despite the label “stock,” these co-op memberships were not securities because “the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.”[[107]](#footnote-106)

For a cooperative wishing to solicit memberships in multiple states, the offer of memberships would likely not be a securities offering for federal law purposes if the memberships entitle members to use the cooperative’s services but do not give the members any interest in profits or assets, cannot be sold, and do not increase in price. However, the law of each state where the memberships are to be offered would also apply; the practitioner would need to determine whether the memberships are securities or not under state law.

### What Is a Security? (California Law)

The California definition of “security” is found in the Corporate Securities Law of 1968, [Corp. Code section 25019](http://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=25019.). The analysis of whether an investment of money into a cooperative is a “security” under California law differs from the analysis under federal law. Many states, including California, use the risk capital test in addition to the Howey test.

According to the risk capital test, any arrangement in which someone puts their money at risk in order to capitalize a new enterprise could be considered a security, even if the person does not expect a return on investment. The case that controls in California is [*Silver Hills Country Club v. Sobieski*](https://scocal.stanford.edu/opinion/silver-hills-country-club-v-sobieski-29868) *55 Cal. 2d 811 (1961)*.[[108]](#footnote-107) The facts of that case were as follows: founders who planned to open a new country club paid a downpayment to purchase property for the club. Then they sold “charter memberships” in order to finance improvements including a swimming pool, showers, and a steam room. The founders planned to continue selling memberships to members who would then use the country club. The problem was that the founders used the presale of memberships as a scheme to capitalize a club that needed substantial development before it could be opened, but the offering of memberships was neither registered with California securities regulators nor exempt.

The country club founders argued that the memberships were not within the scope of securities laws because the memberships were “purchased, not for investment, but for the use and enjoyment of the purchaser.”[[109]](#footnote-108) This argument did not convince the court. Even though the memberships did not give the members any interest in the club’s assets or profits, the California Supreme Court held that the Corporate Securities Law of 1968 extends to “transactions where capital is placed without expectation of any material benefits”[[110]](#footnote-109) and that the charter memberships were securities because the club founders were “soliciting the risk capital with which to develop a business for profit.”[[111]](#footnote-110)

Presales of products and services are commonly used by businesses for cash flow and marketing reasons. To help distinguish when a pre-sale would be considered a security, look to the court’s reasoning in Silver Hills: “Only because [they] risk [their] capital along with other purchasers can there be any chance that the benefits of club membership will materialize.”[[112]](#footnote-111)

**Key takeaway: If a cooperative plans to ask people to put their money at risk in order to start or build an enterprise, make a plan to comply with securities laws.**

### Registration and Exemptions

If a cooperative will raise capital by offering and selling securities, then federal and state securities laws require the offering to be registered unless it is eligible for an exemption. When a company goes public or does an IPO (initial public offering), it is registering a securities offering with the [Securities and Exchange Commission](http://sec.gov) (SEC) under the federal [Securities Act of 1933](https://www.govinfo.gov/content/pkg/COMPS-1884/pdf/COMPS-1884.pdf)[[113]](#footnote-112) and doing a coordinated registration with every U.S. state. If an offering will be made only in one or a few states and can fall within a federal exemption, the offering can be registered under state law only. The California [Corporate Securities Law of 1968](https://leginfo.legislature.ca.gov/faces/codes_displayexpandedbranch.xhtml?tocCode=CORP&division=&title=4.&part=&chapter=&article=&nodetreepath=6)[[114]](#footnote-113) and [California Code of Regulations title 10, chapter 3, subchapter 2](https://govt.westlaw.com/calregs/Browse/Home/California/CaliforniaCodeofRegulations?guid=I0F5152D02BCF11E4A6D6D3F1F2EE3B20&originationContext=documenttoc&transitionType=Default&contextData=(sc.Default))[[115]](#footnote-114) provide for registration of an offering of securities for sale to the public (called “qualification by permit”). The expense of registration at the federal level is high enough to be prohibitive for all but large companies. Even registration at the state level is onerous and is not done if the client’s goals can be met with less time and expense under an exemption.

Cooperatives, like any other for-profit enterprise, can raise capital under a number of exemptions. In addition, most states have an exemption for cooperative memberships. California’s exemption provides that cooperative memberships with voting rights can be sold to the public under [Corp. Code section 25100(r).](https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=CORP&division=1.&title=4.&part=2.&chapter=1.&article=) This exemption is discussed in the next section relating to member investment.

The chart below summarizes the securities strategies available and the information enterprise leaders may need to make a business decision about securities strategy. Cooperatives can and do use all of these strategies. This chapter focuses on California worker-cooperative corporations and discusses the California exemption for cooperative-corporation memberships in the section entitled [Preferred Shares and Community Investor Members in a Cooperative Corporation](#_waupy610ob2r) below. Guidance on how to prepare a client for the other offering types is beyond the scope of this chapter. The practitioner should be aware of the full range of options available, however, in order to put the cooperative exemption in context and to help a client choose a strategy.

| **Securities law strategy:** | Private offering | California exemption for cooperative memberships/stock | National regulation crowdfunding | California registered offering | Reg A Tier II, public national offering |
| --- | --- | --- | --- | --- | --- |
| **Total raise amount allowed:** | Unlimited | Unlimited | $5M | Unlimited | $75M |
| **Cost to do (approximate):** | $5K–15K depending on the extent of disclosure materials | $5K–7.5K | $5K–12K, plus ~7% of total raise (portal fee); plus costs of audited or reviewed financials | $20K–35K, plus $2.5K (max) state filing fee; plus cost of audited or reviewed financials | $40K–$100K; plus cost of audited financials |
| **Ongoing costs:** | None | None | None | None | Ongoing SEC reporting – $15K–50K/year |
| **How much an individual can invest:** | Unlimited, but most investors must be accredited (high net worth) | $1K max | $2K or greater depending on net worth/income | Can depend on regulator discretion, generally at least $2.5K | 10% of the greater of annual income or net worth, or more for high income/  wealthy |
| **Public?** | No general solicitation, no ads | Yes | Limited; must use registered portal | Yes | Yes |

## Patron-Member Investment

Cooperatives of all kinds usually raise capital first from members. It is common for any kind of enterprise to start with contributions from founders. The amount of capital that founders of a worker cooperative contribute to start or grow a new co-op varies widely, depending on the number of founders, the economic circumstances of the founders, the industry, and how much capital is needed. Some worker cooperatives have been started using only founder contributions. Others must raise most of the needed capital from other sources.

### Patron-Member Equity in Cooperative Corporations Formed Under the Cooperative Corporation Law

*Form: Shares or Memberships*

If a worker cooperative chooses to organize as a corporation, it will likely use the Cooperative Corporation Law, Corp. Code sections 12200 to 12704. This law allows cooperatives to form with or without stock—a cooperative can be a “stock cooperative” or a “nonstock cooperative.”

If a cooperative chooses to represent its equity with stock, then the worker-members are the owners of the cooperative’s common stock. The cooperative will issue one and only one share of common stock to each worker-member when they join, and will generally buy that share back when the worker-member leaves the cooperative. The share of common stock represents the worker-member’s proprietary interest. Common stock in a worker-cooperative corporation generally does not bear dividends but entitles the worker-member to share in patronage dividends. However, dividends on stock are permitted up to 15% of the shareholder’s contributions to capital.[[116]](#footnote-115) Voting power of worker-members is best thought of as a personal right or a right that is part of membership rather than a right of a share of stock.[[117]](#footnote-116)

The purchase price of a share of common stock in a worker-cooperative is the worker-member’s first contribution to the cooperative’s capital.

If a worker cooperative corporation decides that there is no need for stock and forms instead as a “nonstock” cooperative, then the cooperative will charge a membership fee to new members. The purchase price of a membership or the initial membership fee is the worker-member’s first contribution to the cooperative’s capital.

*Securities Exemption*

Shares and memberships of cooperative corporations are exempt from registration (Corp. Code section 25100(r)). In general, a request to contribute money (other than as a gift) in order to start or grow an enterprise should raise the issue of securities law compliance (see above). However, cooperatives formed under California’s Cooperative Corporation Law can offer and sell their memberships or membership stock, up to $1,000 per member, to the public in California without the need to register the offering, relying on the exemption in Corp. Code section 25100(r). Worker cooperatives can rely on this exemption when they receive a membership fee in exchange for a worker-membership or sell a share of stock that represents the buyer’s rights as a worker-member.

A full discussion of this exemption, including how it applies to community investors, is included in the section called [“Outside” Equity](#_wku22ucipa51) below.

### Patron-Member Equity in LLC Worker Cooperatives

*Form: Capital Contributions*

The owners of limited liability companies (LLCs) are called “members.” If a worker cooperative chooses to organize as an LLC, the LLC’s members will be all of the cooperative’s worker-members. LLC co-ops usually require a new member to make a payment in order to become a member. That payment (the purchase price of a membership) will be the member’s “initial capital contribution” and will be added to the member’s capital account on the LLC’s books.

*Securities Law Analysis for Founding Members’ Interests*

The common situation is that a founder receives an equity interest in an LLC in their role as a founding member of the company; the number of founding members is relatively small; all of those founding members control the company together; and all of the members are residents of California. In this situation, federal law likely would not view the membership interests as securities because the founders are managing the company themselves, and they are not expecting profits primarily from the managerial efforts of others.[[118]](#footnote-117) In addition, if the company and all members reside in California, the federal intrastate exemption would likely apply, so federal registration requirements would not apply even if the membership interests were securities.[[119]](#footnote-118) For these reasons, if all persons receiving an LLC membership interest will be participating in management, there is no need to take any action to comply with an exemption under federal securities law.

In California, membership interests of members who manage an LLC are excluded from the definition of “security.” The definition of “security” under the Corporate Securities Law of 1968 includes:

interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company[.][[120]](#footnote-119)

If an LLC co-op is member-managed (rather than manager-managed), and if all members do in fact actively engage in the management of the LLC, then the membership interests of those members are not securities under California law. In a dispute, the burden would be on the LLC to prove that all members do engage in management. Therefore, a best practice is to create documentation showing that all members do in fact participate in management. This documentation could include an operating agreement that describes how all members participate in management decisions,[[121]](#footnote-120) and minutes of member meetings documenting members’ participation. You could also document member management by showing that all members made proposals or had an area of decision-making authority. Creating documentation and dispersed management practices has a cost in time and legal fees. The practitioner should guide the worker-owners to weigh this cost against the potential risk of a dispute or regulatory action based on an alleged securities law violation.

Even though the membership interests in a member-managed LLC are not securities, it is common practice to file a notice filing under Corp. Code section 25102(f) any time an LLC issues a membership interest. Section 25102(f) exempts offers or sales of securities in a transaction in which there are no more than 35 purchasers, all of whom have a preexisting relationship with the seller.[[122]](#footnote-121)

### Member Loans

Members can capitalize their cooperative by making a loan to the co-op. The terms of such a loan should be agreed and documented. A member loan should be “subordinate,” meaning that if the co-op will need another loan from a bank or other institution, that institutional loan will have the first priority to payments and to any security interest in the cooperative’s assets. A loan from a member to their cooperative will likely be exempt from registration under exemptions for private transactions in both federal and California securities laws. In a typical situation, a loan would be done privately, with no public solicitation. In that case, the transaction would be exempt under section 4(a)(2) of the federal Securities Act of 1933, and it would likely be exempt under both section 25102(e) and section 25102(f) of California’s Corporate Securities Law of 1968.

## “Outside” Equity

The terms “outside equity” and “outside investors” are used here for convenience to refer to investments by people other than the worker-members. Note too that most offerings open to outside investors are also open to worker-members. A note about terminology is needed here. Confusion often arises when talking about “outside investors” because people tend to use words in a way that is different from their legal meaning. Note that any equity holder in a California cooperative corporation is a “member”; in contrast, other cooperative legal entities can have equity holders who are not “members” (such as the California agricultural cooperative corporations). Cooperators often use the word “member” to mean “patron member” and refer to investors as “nonmembers.” Practitioners should pay close attention to word choice.

Cooperatives face certain constraints that other businesses do not with respect to raising capital from “outside equity.” These constraints come from cooperative principles as codified by subchapter T of the Internal Revenue Code[[123]](#footnote-122) and from state law. Also, cooperatives must navigate the tension between long-term patron-member ownership and the need to provide an “exit” for investors.

### Legal Constraints on Outside Equity

*Operating on a Cooperative Basis and Subordination of Capital*

Cooperatives must be organized primarily to benefit members as patrons; if the organization primarily directs profits to owners on the basis of their equity ownership, then it is not a cooperative. This concept underlies the cooperative principles.[[124]](#footnote-123) It is also codified in U.S. tax law. Subchapter T of the Internal Revenue Code[[125]](#footnote-124) provides a tax advantage for “any corporation operating on a cooperative basis”[[126]](#footnote-125) (with some exclusions).

Case law interpreting subchapter T tells us that “operating on a cooperative basis” means that the entity is organized and operating primarily for the benefit of members as patrons, not primarily to direct profits to shareholders.[[127]](#footnote-126) In the landmark case[[128]](#footnote-127) on what “operating on a cooperative basis” means, the U.S. tax court discussed “guiding principles” that form the “core of economic cooperative theory”; these guiding principles formed the basis for finding that the taxpayer was “operating on a cooperative basis” for the purpose of subchapter T.[[129]](#footnote-128) One of these guiding principles was the “[s]ubordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom[.]”[[130]](#footnote-129)

*Cooperatives May Pay Limited Dividends on Capital*

Dividends on stock are consistent with “operating a cooperative basis,” but only if those dividends are limited. The upper limit of dividend rates a cooperative may pay is a gray area. There is little guidance regarding what level of returns on capital a cooperative can pay and still be “operating on a cooperative basis” for the purpose of subchapter T. We know that a dividend of 8% of paid-in capital is acceptable: that was the limited dividend deemed acceptable in *Puget Sound Plywood, Inc. v. Commissioner.*[[131]](#footnote-130) Also, the federal Capper-Volstead Act authorizes agricultural producer cooperatives and provides that mutual marketing will not be considered an antitrust violation, but only if the cooperative pays no more than 8% dividends on stock or membership capital.[[132]](#footnote-131) The California Cooperative Corporation Law[[133]](#footnote-132) limits dividends on stock to 15% of contributed capital per year,[[134]](#footnote-133) and we can conclude that cooperatives operating within this limit are also within subchapter T. In general, cooperatives selling preferred shares usually offer a dividend rate in the 2% to 7% range. If a client proposes to pay a high dividend rate or a significant percentage of a cooperative’s profits to investors, the practitioner should raise the issue that this may cause the organization not to be “operating on a cooperative basis” under Internal Revenue Code subchapter T.

*Pushing the boundary:* In some cases, cooperative founders will feel pressure to offer a greater return to investors. A greater dividend on preferred shares may be allowed under subchapter T, but this approach may be risky as it rests on less authority. It has been argued that as long as a cooperative pays less than half of its net income to investors, it is still “operating on a cooperative basis.” The authors do not recommend relying on that argument. If a cooperative deducts patronage dividends, and then is later found not to have qualified for cooperative tax treatment under subchapter T, that organization would owe back taxes. For this and other reasons, most clients do not want to be the test case for this scenario. Therefore, if a cooperative wants to accept investment from investors who require a higher rate of return, the practitioner should explore different approaches. These could include offering a debt instrument or entering into a business relationship with a noncooperative investor-owned entity. Please also note that if an entity exists primarily to accept investments and then invests in another business, the Investment Company Act of 1940 could apply, and the practitioner should be confident that an exception under that Act applies before recommending a legal structure for investment.[[135]](#footnote-134)

**Key takeaway: If a cooperative proposes to give a large percentage of profits to investors, the practitioner should raise the issue of subchapter T’s requirement to “operate on a cooperative basis.” Check whether the cooperative plans to deduct patronage dividends under subchapter T, and if so, limit the rate of dividends on capital or offer debt.**

**Key takeaway: A California cooperative corporation can pay up to a 15% dividend on contributed capital per year, and patronage dividends are unlimited.**

*LLC co-ops taxed as partnerships are not subject to the constraints discussed above:* LLC co-ops taxed as partnerships are not corporations for tax purposes and do not need to comply with subchapter T of the Internal Revenue Code. The California Revised Uniform Limited Liability Company Act does not require companies formed under that law to be democratically owned and controlled by the members. Instead, it allows LLCs to share voting rights and economic rights as the members agree in their operating agreement. An LLC co-op is limited only by its own goals and adherence to cooperative principles. A worker-owned LLC may legally offer a substantial percentage of profits to a nonworker investor.

### Preferred Shares and Community Investor Members in a Cooperative Corporation

“Preferred shares” is a general term that refers to any class of stock with preferential rights added to attract investment. The preferences usually include the right to be paid a dividend before holders of common stock are paid, and the right to receive at least the purchase price of the stock in the event of liquidation before any distribution goes to holders of common stock. Preferred stock often has limited voting rights.

California cooperative corporations may have different classes of shares and may specify the rights, privileges, preferences, and restrictions on the different classes.[[136]](#footnote-135) This allows cooperatives to create classes of stock to represent additional capital contributions from patron members or to raise capital from outside investors. Typical terms of preferred stock for investors would include a dividend (no greater than 15% of contributed capital per year, but often in the 2% to 7% range), a preference in the event of dissolution, and the right to sell the shares back to the cooperative, which may be subject to the cooperative’s discretion or conditioned on cash being available. (A nonstock cooperative may create a class of membership with these rights, but “preferred shares” will be better understood by investors. A nonstock cooperative could change to a stock cooperative by amending its articles. The amendment should specify the effect of the amendment on current members.)

A California cooperative corporation may sell preferred shares to raise capital, and may do so publicly to California residents, under the exemption in Corp. Code section 25100(r). That exemption provides that offers and sales of the following are exempt from the registration requirement:

(r) Any shares or memberships issued by any corporation organized and existing pursuant to the provisions of Part 2 (commencing with Section 12200) of Division 3 of Title 1, provided the aggregate investment of any shareholder or member in shares or memberships sold pursuant to this subdivision does not exceed one thousand dollars ($1,000). This exemption does not apply to the shares or memberships of that corporation if any promoter[[137]](#footnote-136) thereof expects or intends to make a profit directly or indirectly from any business or activity associated with the corporation or the operation of the corporation or from remuneration, other than reasonable salary, received from the corporation. This exemption does not apply to nonvoting shares or memberships of that corporation issued to any person who does not possess, and who will not acquire in connection with the issuance of nonvoting shares or memberships, voting power (Section 12253) in the corporation[.]

About this exemption:

* This exemption is available only for cooperatives organized under the Cooperative Corporation Law, Corp. Code sections 12200 to 12704.
* The exemption is for memberships, membership equity, or shares representing membership. This exemption does not apply to debt offered by a cooperative.
* The only kind of paid representative who can offer and sell a cooperative’s shares or memberships is an employee being paid a reasonable salary. The shares or memberships cannot be offered or sold using a broker/any representative who would receive a commission or by a preferred shareholder expecting a share of non-patronage-related profits.
* This exemption only applies to the first $1,000 that any member invests in their cooperative. This means that if worker-owners contribute more than that, they will need to rely on another exemption (which should be easy because section 25102(f) would likely be available).
* The exemption means that the offering does not need to be registered, but anti-fraud provisions still apply. The cooperative and the members in charge of the offering must make sure to disclose all information that a reasonable potential investor might want to consider in making the decision to invest or not.

Note that shares of cooperative stock can be offered and sold under this exemption only to members who have voting power or will have voting power when they receive the shares. “Voting power” means “the power to vote for the election of directors.”[[138]](#footnote-137) The result is that a cooperative can issue nonvoting preferred stock to its voting members under this exemption (but only up to $1,000 per person total) and raise capital from the public by issuing preferred stock (up to $1,000 per person), if those investors become voting members, but a cooperative cannot issue nonvoting preferred stock to nonvoting investors under this exemption.

Having all shareholders become voting members is fitting for a consumer cooperative, which is the type of cooperative contemplated by section 25100(r). However, under section 25100(r) and the definition of “voting power” cited above, worker cooperatives could not issue equity to investors without losing control of their cooperative. This is why [AB 816, the Worker Cooperative Act](https://www.theselc.org/governor_brown_signs_california_worker_cooperative_act), was drafted to provide for a class of membership with “voting power” that would meet the requirement of securities exemption 25100(r), but that voting power is nevertheless very limited. AB 816 was passed and became effective Jan. 1, 2016.

AB 816 added the definition of “community investor” to section 12238. “Community investor” means “a person who is not a worker-member and who holds a share or other proprietary interest in a worker cooperative.” Section 12253(c) provides: “Community investor voting power in a worker cooperative shall be provided in the articles or bylaws, and is limited to approval rights only over a merger, sale of major assets, reorganization, or dissolution. Approval rights shall not include the right to propose any action.” With the addition of these provisions, worker cooperatives can seek investments of up to $1,000 per person from their community of supporters in a public capital campaign; those supporters can reject major decisions that would affect their investment, but all decision-making still rests with the worker-members.

There is a misconception that California securities law contains an exemption for “community investor members.” It does not. Rather, the “community investor member” provisions in the Cooperative Corporation Law allow worker co-ops to benefit from the securities exemption for cooperative memberships and stock, without giving up majority board control.

If given the most limited possible interpretation, the language of section 25100(r) would appear to prohibit worker-owners who sell their cooperative’s memberships under this exemption from receiving patronage dividends. In a worker-cooperative corporation, worker-owners are paid a salary, and if the cooperative is profitable enough, worker-owners will also receive patronage dividends. Those patronage dividends would be a “profit directly or indirectly from” a “business or activity associated with the corporation or the operation of the corporation” (Corp. Code section 25100(r)).

This language comes from the past—this law was originally for consumer cooperatives. The prohibition against having anyone sell the co-op’s stock who will profit from the co-op’s operation makes sense in that context. Consumer cooperatives need a way to reach the public to invite people to join, within limits that protect members of the public—dollar amount limits, and limits on profit-making schemes. This law was changed in 2016 to remove the word “consumer” from the title of the law and to add provisions specific to worker cooperatives, making it clear that worker cooperatives are a type of co-op that can be formed under this law.

Practically speaking, if memberships or membership shares are being sold in the start-up phase of a worker cooperative, the co-op could fairly determine that it will not be profitable in the next few years, and therefore the worker-owners do not “expect” or “intend” to share in any profits over their salaries.

| **Word Choice: Community Investor Members**  “Community investor member” is a descriptive term that brings to mind a large network of people who invest relatively small amounts of money in a cooperative because they care about the cooperative’s success. It brings to mind crowdfunding and community support. For this reason, people sometimes use the term “community investor” or “community investor member” in a general sense to refer to investors in any community-based capital campaign by a cooperative. “Community investor member” is also a defined term in the California Cooperative Corporation Law.[[139]](#footnote-138) Under California law, a “community investor member” is a member of a worker cooperative who is an investor, is not a worker, and has very limited voting rights. Attorneys should be aware that this term now has both a technical and a general meaning. |
| --- |

**Key takeaway: A worker cooperative can offer and sell shares of stock to California residents, using general solicitation, without giving investors the right to vote for directors, if it does all of the following:**

* **make sure the offering is intra-state, to comply with federal securities law;[[140]](#footnote-139)**
* **make sure no shareholder owns more than $1,000 of the cooperative’s stock in aggregate;**
* **designate itself as a worker cooperative in its articles of incorporation;**
* **have articles or bylaws that designate the stock to be offered, define it as “community investor” stock, and define voting power that is “limited to approval rights only over a merger, sale of major assets, reorganization, or dissolution,” and do not include the right to propose any action.**

### Other Securities Law Strategies Are Available

Section 25100(r), discussed above, provides a useful securities law exemption for cooperatives incorporated under the Cooperative Corporation Law to offer and sell their memberships, but cooperatives are not limited to relying on that exemption. A cooperative may offer and sell securities under any federal and state law exemption, or may register an offering. The cooperative and its advisers must make sure that the cooperative is still complying with the Cooperative Corporation Law and subchapter T of the Internal Revenue Code (if patronage dividends are to be deducted). But the number of holders of investment shares and the amount of capital raised from investment shares is not limited by the Cooperative Corporation Law or subchapter T.

Some California cooperatives have registered nonvoting stock with the California securities regulators in order to provide patronage dividends to members in the form of stock in amounts that would add up to more than $1,000 per member.[[141]](#footnote-140) A registration could also be done for the purpose of raising capital. A cooperative may also raise capital in a private offering, rely on Regulation CF to run a crowdfunding campaign through a registered portal, and raise capital in a Regulation A offering. Please refer to the section entitled [Registration and Exemptions](#_krohl41houxc) above.

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# Chapter 8: Labor & Employment Law Considerations

*Neil Helfman, Esq.*



## Introduction

The application of labor law to worker cooperatives is both settled and unsettled.

It is settled because under California law, one performing work and labor for another is prima facie evidence of employment and such person is presumed to be an employee in the absence of evidence to the contrary.[[142]](#footnote-141) It is a mixed question of law and fact whether an employment relationship exists.[[143]](#footnote-142) Once the controlling facts are determined, the question of whether a person is an employee becomes one of law.[[144]](#footnote-143) There are no present exceptions for workers who are members of worker cooperatives.

It is unsettled because the statutes, regulations, and case law defining an employment relationship do not apply to the circumstances found in worker cooperatives, have not been examined or analyzed in light of these circumstances, and seek to remedy problems that may not exist. This disconnect only increases with newly emerging working relationships in the digital age, where members of worker cooperatives interact from different locations, often their own homes. Certainly, the application and enforcement of labor laws concerning rest breaks, meal breaks, and overtime are more challenging with remote workers. Cooperative associations also do not fit into prevailing legal structures. They are neither partnerships nor ordinary business corporations whose distinct character has been given statutory recognition.[[145]](#footnote-144)

Legislatures and some courts have recognized the unique characteristics of worker cooperatives. Cooperatives operate on different foundational principles than corporations.[[146]](#footnote-145) Whereas the corporate structure separates control and management, the essence of a cooperative requires that these functions be integrated. Any definition of a cooperative must account for four operationally unique principles: (1) The cooperative is owned and democratically controlled by the producers who use its services. (2) The cooperative distributes its net income to the producers in proportion to their use of the cooperative. (3) Returns on ownership capital are limited. And (4) producers who use the cooperative substantially finance its operation.[[147]](#footnote-146)

While the above observations pertain to cooperatives in general, the unique operational structure of worker cooperatives has also been recognized:

The worker type of cooperative … was intended to provide an alternative to the corporation-for-profit form of organization for conducting manufacturing enterprises. Under the corporation-for-profit form of organization, the profit of the enterprise is vested in outside parties who supply the equity capital which is placed at the risk of the business; who select the management and assume the direction over the enterprise; whose separate corporate entity employs workers that derive only those wages which they are able to obtain through bargaining with the representatives of the equity owners; and which equity owners then receive directly or indirectly the benefit of such net profits as the corporation-for-profit form of organization may produce. Under the cooperative association form of organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as co-owners, in proportion to the amounts of their active participation in the cooperative undertaking.[[148]](#footnote-147)

More recently the U.S. Congress issued House Resolution 602 “[c]ommending the cooperative business models … for their contributions to the economy and social impacts they make on their communities.”[[149]](#footnote-148) In a particular reference to worker cooperatives, it states, “[I]n worker cooperatives members both perform the work and govern the business” and “… in recent years, many businesses are choosing to structure this way so that workers have greater control over the business in which they work and own.” Consequently, House Resolution 602:

1. commends the cooperative business model for its contributions to the nation’s and the world’s economy, the jobs it creates, and its social impacts on the communities in which they operate;

2. expresses its confidence in and support for cooperatives toward continuing their successes;

3. will seek to enact legislation ensuring that cooperatives won’t be adversely affected;

4. will be mindful in crafting legislation affecting other business models so that the legislation does not adversely affect the cooperative business model’s competitive position; and

5. will seek to enact legislation studying, supporting, encouraging, and promoting the use of the cooperative business model across all policy areas that can be an additional alternative toward helping solve a number of the nation’s and the world’s policy issues and concerns.

In some ways, cooperatives are uniquely favored by the law.[[150]](#footnote-149) This favorable treatment is found in federal income tax law that distinguishes cooperatives from other business organizations by the fact that they are eligible for certain special deductions set forth in subchapter T.[[151]](#footnote-150) It is further found in the immunity from the Sherman Antitrust Act provided to marketing co-ops,[[152]](#footnote-151) and it could be argued that the distinguishing characteristics of a co-op could provide immunity from securities laws.[[153]](#footnote-152) Moreover, California and other states have enacted statutes that distinguish cooperative corporations, and there are separate cooperative statutes for both state and federal taxation. But when it comes to labor and employment law, especially given the conflicts inherent in a labor system where the cooperative members are both the workers and the boss, there are no statutes and very little case law.

For practitioners this means that a lot of work needs to be done in employment law to promote the U.S. Congress’s objectives to “to enact legislation studying, supporting, encouraging, and promoting the use of the cooperative business model.” As detailed below, presently, trying to apply labor and employment laws to worker cooperatives is like trying to put a square peg into a round hole. When reading the case law, it’s important to note that many cases discussing who is and who is not an employee are distinguishing between employees and independent contractors; they are not addressing the more unique question of the employment status of workers who jointly own and operate their business. Practitioners who map the legal landscape, recognizing that (1) much of the case law is not exactly on point and may not apply logically or coherently to worker-owned businesses and (2) employment law statutes were not designed for worker-owned businesses but rather to protect workers from abuses by companies owned by others, are better positioned to help their cooperative business clients navigate the muddy waters, weigh risks, and decide how best to make sense of and comply with our current employment laws.

As discussed below, the current prevailing tests for determining whether a worker who provides services for a business is an employee are the common law test, the economic realities tests, and the ABC test. These are the square pegs.

## 

## Tests Used by the Courts to Determine a Worker’s Status as an Employee

### Common Law Test

The common law test to distinguish employees from independent contractors was developed to define an employer’s vicarious liability for injuries.[[154]](#footnote-153) But “… the basic inquiry of compensation law is different.”[[155]](#footnote-154) Federal courts have long recognized that the distinction between tort policy and social legislation justifies departure from common law principles.[[156]](#footnote-155) Recently the California Supreme Court commented on [Borello](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1989044696&pubNum=0000233&originatingDoc=I13943c80aa3511e7a94fe1d3bccdca84&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)), observing:

[A]s we explained in [[Borello](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1989044696&pubNum=0000233&originatingDoc=I13943c80aa3511e7a94fe1d3bccdca84&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite))], the common law test of employment is not always appropriate beyond the tort context in which it was originally developed . . . Outside of tort, rather than “rigidly” applying the common law test, we look to the “history and fundamental purposes” … of the statute at issue to determine whether the Legislature intended the test to apply.[[157]](#footnote-156)

The most significant element of the common law test is the element of control. This factor is not as concerned with the hiring entity’s control over the details of a worker’s work as it is with determining whether the hiring entity has retained “necessary control” over the work.[[158]](#footnote-157) The fact finder first seeks to determine the issue of employment on the basis of control, and when that is not sufficient, other factors are considered.[[159]](#footnote-158) The California Supreme Court held that this standard applies when determining who is an employee when a meaningful definition is not otherwise provided by federal statutes.[[160]](#footnote-159) The IRS has also adopted a variation of this that lists secondary factors.[[161]](#footnote-160)

### The Economic Realities Test

This Economic Realities Test has been adopted by the Federal Fair Labor Standards Act (FLSA), and is directed to the question of whether or not an employment relationship is an “economic reality.”[[162]](#footnote-161) It does not depend on isolated factors but rather upon the circumstances of the whole activity, and the touchstone is economic reality.[[163]](#footnote-162) These cases interpret the “suffer or permit to work” definition of “employ” in the FLSA[[164]](#footnote-163) as intended to treat as employees those workers who, as a matter of economic reality, are economically dependent upon the hiring business, rather than realistically being in business for themselves. In making this determination, lower federal court decisions generally refer to a list of factors, many of which are also considered under the common law standards, including:

(1) the degree of control exercised by the employer over the workers, (2) the workers’ opportunity for profit or loss and their investment in the business, (3) the degree of skill and independent initiative required to perform the work, (4) the permanence or duration of the working relationship, and (5) the extent to which the work is an integral part of the employer’s business.[[165]](#footnote-164)

The Goldberg v. Whitaker House Coop case[[166]](#footnote-165) that applied this standard is presently the most significant labor law decision affecting worker cooperatives and has been used by subsequent courts as precedent to determine employment relationships in worker cooperatives.

### The ABC Test

The California legislature in AB-5 codified the holding of the California Supreme Court,[[167]](#footnote-166) which set forth a three-factor ABC test to determine whether a worker is an independent contractor or employee for purposes of the California Industrial Welfare Commission’s wage orders. According to the ABC test established by the [Dynamex](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=2044427625&pubNum=0007052&originatingDoc=I0045b9b0e10f11eabaabff88df14112a&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)) court, a worker should be considered an employee unless the hiring entity establishes the following three factors: (A) the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work, and in fact, (B) the worker performs work that is outside the usual course of the hiring entity’s business, and (C) the worker is customarily engaged in an independently established trade, occupation, or business. AB-5 applies the ABC test to the entirety of the California Labor Code and the California Unemployment Insurance Code, with the possible exception of the workers’ compensation law.[[168]](#footnote-167)

The ABC test “presumes a worker hired by an entity is an employee and places the burden on the hirer to establish that the worker is an ‘independent contractor’ by showing each of parts A, B, and C.”[[169]](#footnote-168) The failure to establish any one prerequisite is sufficient “to establish that the worker is an included employee, rather than an excluded independent contractor, for purposes of the wage order.” Unlike a multifactor test, the ABC test “allows courts to look beyond labels and evaluate whether workers are truly engaged in a separate business or whether the business is being used by the employer to evade wage, tax, and other obligations.”[[170]](#footnote-169)

## 

### The Restatement of Employment Law Test

In 2015, the American Law Institute set forth standards for defining employment that, in addition to control, also considered the entrepreneurial opportunity provided to the worker.[[171]](#footnote-170) While California has not adopted this standard, or applied it to the ABC standard that it did adopt, it may provide a more realistic starting point for determining the employment relationship in a worker cooperative instead of one that is based on whether or not the worker is “engaged in a separate business.”

These tests, and any future tests that apply to worker cooperatives, should consider the underlying purposes of labor laws and how they apply to worker cooperatives, as well as public policy issues. But, as noted by the federal district court in an unpublished decision, a test used to determine whether a worker is an independent contractor provides only “limited assistance” when there are other work arrangements.[[172]](#footnote-171) The same could be said of worker cooperatives in regard to all of the above tests, with the possible exception of the Restatement, because none of these tests take into consideration that worker-members own and run the business for which they provide services and that worker-owners assume all the benefits and risks of being an entrepreneur, in addition to being a worker providing services.

Structurally, the inherent conflict between capital and labor that underlies these tests should not exist in worker cooperatives. An owner of a traditional for-profit business wants to keep profit as high as possible and wages as low as possible, while workers in that business want wages as high as possible and business profit is not their concern. And since the owner of such a business usually has more economic leverage, the owner normally sets employee compensation. In contrast, in worker cooperatives, both wages and profits (in the form of patronage distributions) go to the worker-members who control their business and determine wages and patronage distribution. Thus, worker cooperatives eliminate the conflict of interest between wages and profit. An examination of the reasons for the current labor laws reveals the need for change when applied to worker cooperatives and informs the direction that change should take.

## Applying Labor Laws to Worker Cooperatives

The goal of both workers’ compensation law and the Labor Code’s wage and hour provisions is to protect a class of workers who otherwise would not enjoy statutory protections.[[173]](#footnote-172) Thus, the Labor Code and wage orders should be constructed to best give effect to the legislature and the Industrial Welfare Commission (IWC) to protect workers in regard to working conditions, wages, and hours.[[174]](#footnote-173) But the “control” test for determining whether a person rendering services is an employee or independent contractor must be applied with deference to the purpose of the legislation, the nature of the work, and the overall arrangement between the parties.[[175]](#footnote-174) In fact, California’s Workers’ Compensation Act is not limited to common law principles in defining employment and instead “must be construed with particular reference to the history and fundamental purpose of the statute.”[[176]](#footnote-175)

Although labor laws should be constructed to give the relief the legislature intended, liberal construction should not be used as a pretext to create liability where none exists or was intended.[[177]](#footnote-176) “In construing a remedial statute ‘reason must have its just proportion.’”[[178]](#footnote-177) In other words, labor laws should not be applied to worker cooperatives without thoughtful consideration of a worker cooperative’s operational structure.

Are members of worker cooperatives within the class of workers whom the legislature determined need statutory protection? Whom do these worker-owners need protection from: themselves? If not, should existing labor laws apply to them? Answers to these questions should lead to employment laws for worker cooperatives that are aligned with their operational structure. While the wage and hour and working condition protections are important public policies, these protections can be integrated in new ways that account for the working relationships in worker cooperatives. The workers in cooperatives, unlike workers for hire, have control over all of these matters. House Resolution 602 noted that worker cooperatives “perform the work and govern the business …” and that in recent years, the reason “many businesses are choosing to structure this was so that workers have greater control over the business in which they work and own” (emphasis added). It also found that worker cooperatives further public policies by making contributions to the economy and society, and as a result of this public policy, thus, the house resolved “… to seek to enact legislation ensuring that cooperatives won’t be adversely affected” and “… will be mindful in crafting legislation affecting other business models so that the legislation does not adversely affect the cooperative business model’s competitive position.”

Unfortunately, in spite of the pronouncements of Congress, worker cooperatives must deal and comply with labor and employment laws as they presently exist. To this end the following section will set forth labor and employment laws that apply to all workers, including worker cooperative members, case law pertaining to worker cooperatives, options available to worker cooperatives under the existing laws, some recommended practices, criticism of existing labor laws, and a proposal for the changes in the law. Although the following section will primarily focus on labor and employment laws that have an economic impact, it will also explore some noneconomic issues.

### Regulation of Employment in California

#### Department of Industrial Relations

California established the Department of Industrial Relations (DIR) to “foster, promote, and develop the welfare of the wage earners of California.”[[179]](#footnote-178) Its duties are set forth in the statute.[[180]](#footnote-179) According to the DIR’s website, its mission is to:

… improve working conditions for California’s wage earners and to advance opportunities for profitable employment in California. DIR administers and enforces laws governing wages, hours and breaks, overtime, retaliation, workplace safety and health, apprenticeship training programs, and medical care and other benefits for injured workers. DIR also publishes materials and holds workshops and seminars to promote healthy employment relations, conducts research to improve its programs, and coordinates with other agencies to target egregious violators of labor laws and tax laws in the underground economy.

The DIR is also authorized to cooperate with the appropriate federal agencies in enforcing, within the state, the Fair Labor Standards Act of 1938 (FLSA).[[181]](#footnote-180)

The DIR carries out this mission through various divisions and the IWC.[[182]](#footnote-181) While these divisions address a number of labor matters such as health and safety and apprenticeship, the division pertinent to this section is the Division of Labor Standards Enforcement (DLSE), the administrative agency authorized to enforce California’s labor laws,[[183]](#footnote-182) including applicable wage orders.[[184]](#footnote-183) The DLSE adjudicates administrative complaints alleging violations of state labor laws, including employees’ claims for unpaid wages,[[185]](#footnote-184) and maintains an “administratively and physically separate” enforcement unit “to ensure that minimum labor standards are adequately enforced.”[[186]](#footnote-185)

#### Industrial Welfare Commission

California’s Industrial Welfare Commission (IWC) is composed of two representatives of organized labor who are members of recognized labor organizations, two representatives of employers, and one representative of the general public.[[187]](#footnote-186) The scope of its authority is over wages, hours, and working conditions.[[188]](#footnote-187) It is empowered to issue wage orders governing employment in California,[[189]](#footnote-188) which have the force of law.[[190]](#footnote-189) Absent an element of arbitrariness, courts take IWC wage orders at face value, generously interpreting them for the protection and benefit of employees.[[191]](#footnote-190) “To the extent a wage order and a statute overlap a court will seek to harmonize them.”[[192]](#footnote-191) However, because the legislature is the source of the IWC’s authority, where there is a conflict, a provision of the Labor Code shall prevail over a wage order.[[193]](#footnote-192)

Which wage order applies to a business is determined by the main purpose of the business that has hired employees, and not by the employee’s duties.[[194]](#footnote-193) In actions under this statute to recover unpaid minimum wages, the applicable wage order of the IWC, not the common law, defines the employment relationship.[[195]](#footnote-194) The IWC, as of this writing, has issued a minimum wage order and seventeen other work orders directed to various businesses and occupations. The work orders define “employee” as “any person employed by an employer” and contain three alternative definitions for “employ”: (1) to exercise control over the wages, hours or working conditions, or (2) to suffer or permit to work, or (3) to engage, thereby creating a common law employment relationship.[[196]](#footnote-195) The purpose is to extend protection to workers who would not come within the common law.[[197]](#footnote-196) But some of the work orders also have supplemental definitions of employees for particular occupations such as health care workers.[[198]](#footnote-197) While these definitions indicate the need to address particular employment circumstances, unfortunately the wage orders do not distinguish worker cooperatives.

| **→ PRACTICE NOTE:** Attorneys should advisetheir worker cooperative clients to familiarize themselves with the particular wage order(s) that applies to their business. The wage orders can be found on the DIR’s website. |
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#### Division of Labor Standards Enforcement

As noted above, the DLSE is empowered to enforce California’s labor laws, including IWC wage orders.[[199]](#footnote-198) The DLSE is responsible for administering and enforcing statutes governing wage, hours, and working conditions.[[200]](#footnote-199) The provisions of the Labor Code with respect to time, place, and manner of payment of wages are enforced by the DLSE, which is directed to inquire diligently for any violations.[[201]](#footnote-200) With or without the consent of the employee or employees affected, the DLSE may commence a civil action to recover unpaid minimum wages or overtime compensation, including interest, owing to any employee, together with reasonable attorney fees and costs of suit.[[202]](#footnote-201) The Labor Commissioner is the Chief Executive Officer of the DLSE.[[203]](#footnote-202)

The DLSE also issues opinions. While they are not controlling upon the courts, DLSE opinions may properly provide guidance[[204]](#footnote-203) that may inform the court’s judgment when interpreting the IWC’s wage orders. DLSE opinions that arise from fact-specific adjudications may be persuasive authority for cases with similar facts and circumstances.[[205]](#footnote-204)

### Fair Employment and Housing Act

The basic purpose of the Fair Employment and Housing Act (FEHA) is to safeguard the rights of California residents to seek, obtain, and hold employment without experiencing discrimination because of race, color, sex, national origin, as well as other characteristics.[[206]](#footnote-205) The Act supplements, and does not replace, existing civil rights legislation regarding employment, both state and federal.[[207]](#footnote-206) A bonus or raise in exchange for a release of claims protecting workers under the FEHA from unlawful employment purposes will be unenforceable.[[208]](#footnote-207) Likewise, it is prohibited to require any applicant for employment, or any employee, to waive any right, forum, or procedure, provided by the FEHA.[[209]](#footnote-208) Under the FEHA, it is generally unlawful to discriminate in the workplace on the basis of race, creed, gender, etc., and other characteristics identified by statute.[[210]](#footnote-209) But there is also specific conduct that is prohibited, including discriminatory refusal to hire or train,[[211]](#footnote-210) discrimination in the election of officers or the expulsion or restriction of members of a labor organization,[[212]](#footnote-211) and discriminatory tests and selection procedures.[[213]](#footnote-212) Even “at will” employees are protected by the FEHA if an employee’s termination was motivated by invidious discriminatory attitudes.[[214]](#footnote-213) But if there is no violation of the FEHA, an at-will employee can be fired without cause.[[215]](#footnote-214)

In addition to prohibiting discriminatory conduct, the FEHA requires employers to reasonably accommodate their employees’ religious beliefs and practices, unless doing so creates a business hardship.[[216]](#footnote-215) But accommodation of religious dress is not reasonable if it causes segregation from other employees or the public.[[217]](#footnote-216) An employee who brings an action for discrimination because of creed or religion must show: (1) a sincerely held belief that (2) the employer was aware of this belief and (3) the belief conflicted with work duties or conduct. Employment status is a requirement for making a claim under the FEHA.[[218]](#footnote-217) Under FEHA regulations an employee is defined as “[a]ny individual under the direction and control of an employer under any appointment or contract of hire or apprenticeship, express or implied, oral or written.”[[219]](#footnote-218) Courts have examined employee status through comparison with analogous statutes and regulations, including FEHA’s regulatory definition, the California Labor Code, and Title VII of the Federal Civil Rights Act.[[220]](#footnote-219)

If this employee status is determined, claims under the FEHA can be pursued using the three-stage burden shifting presentation of evidence established by the U.S. Supreme Court in McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973): (1) the plaintiff’s burden to establish a prima facie case by providing evidence that (a) they had a protected characteristic, (b) they were qualified for their position or performed competently in it, (c) they suffered an adverse employment action, and (d) their protected characteristic motivated the action; (2) the employer’s burden to proffer a nondiscriminatory reason for the action; and (3) the plaintiff’s burden to show that the employer’s proffered reasons are pretexts for discrimination or to produce other evidence of a discriminatory motive.[[221]](#footnote-220)

Under the FEHA, to discredit an employer’s proffered legitimate nondiscriminatory reasons for adverse employment action, the plaintiff must demonstrate such weaknesses, implausibilities, inconsistencies, incoherencies, or contradictions in the employer’s proffered legitimate reasons for its action that a reasonable fact finder could rationally find them unworthy of credence.[[222]](#footnote-221) The ultimate factual issue is whether discriminatory animus motivated the employer, not whether the employer is wise, shrewd, prudent, or competent.[[223]](#footnote-222)

### Worker Cooperative Choice of Entity

Under the existing law, in most situations, partners who work in a partnership are exempt from labor laws, while employees, who provide services to corporations, generally are not. This distinction would apply to two identical businesses, one formed as a partnership and the other formed as a corporation. Thus, form takes precedence over substance, and entity choice often determines how employment laws apply to the business. As seen by the cases discussed above, courts routinely apply this mechanical thinking when dealing with worker cooperatives. However, some courts have criticized this mechanistic approach and have suggested a different approach that may be more applicable to worker cooperatives.

#### Partnerships

Under the Uniform Partnership Act of 1994 adopted by California, a partnership is two or more people operating a business together as co-owners.[[224]](#footnote-223) A community of interests along with the sharing of profits and losses in a continuing business are essential elements of a partnership.[[225]](#footnote-224) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received for any of a number of specified reasons, including as payment for services as an independent contractor or wages or other compensation to an employee.[[226]](#footnote-225) Where the existence of a partnership is sufficiently established, it is not necessary that the parties agree to a partnership or a division of profits.[[227]](#footnote-226)

Under this definition any cooperatives that are collectives or unincorporated associations are partnerships in the eyes of the law, whether they recognize it or not. The danger to the cooperative members in this arrangement is that members will not have personal liability protection, because business owners in a partnership are personally responsible, both jointly and severally, for the partnership’s liabilities, including those created by contracts.[[228]](#footnote-227)

To avoid this personal liability, California as well as other states have enacted statutes providing for the creation of limited liability companies (LLCs) that operate as partnerships but provide the liability protection of corporations.[[229]](#footnote-228) [The LLC is managed by its members, and they are agents of the LLC,](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000204&cite=CACRS17703.04&originatingDoc=I976d9215956b11d9a9eaa5d3fe83563f&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)) unless the articles of incorporation state the LLC is governed by a manager.[[230]](#footnote-229) The signature of two or more members can bind the LLC.[[231]](#footnote-230) IRS regulations give LLCs the option to be taxed as a partnership or a corporation.[[232]](#footnote-231) California tax law does the same.[[233]](#footnote-232) Unlike a general partnership where the partnership can be created by conduct, an LLC requires a formal filing with the Secretary of State and payment of at least a minimal annual tax.

There are several reasons why a cooperative may choose to be an LLC, especially at its beginning. A start-up cooperative, with little capital, may have difficulty paying any wage, let alone a minimum wage, and establishing systems to comply with all the laws and regulations governing employers in California. Founding members of a cooperative often work at other jobs part-time in order to earn a living while the start-up gets off the ground, and thus members may not work at the same time or place as other founding members. All of the above makes an employment relationship challenging.

An LLC allows for a patronage distribution because, in a partnership, the division of profits may be left to the parties.[[234]](#footnote-233) An LLC can also create a business that is democratically controlled, if the LLC is run by its members instead of a manager. Cooperative LLCs should include in their operating agreement the “one person, one vote” language indicative of a cooperative, as well as language governing patronage distributions.

| **→ PRACTICE NOTE:** As a cooperative LLC becomes sufficiently profitable, it may want to convert to a cooperative corporation[[235]](#footnote-234) to take advantage of the special tax provisions for cooperatives in subchapter T of the IRC. While a discussion about when, why, and how to convert is beyond the scope of this section, it’s worth noting that laws governing worker cooperative entity conversion may be on par with existing labor and employment laws in providing wholly inadequate guidance and clarity. This deficiency should be addressed in future efforts to create a comprehensive legal system applicable to worker cooperatives. Until that time, worker cooperatives contemplating converting from an LLC to a corporation should seek the advice of legal counsel. Practitioners new to this work should research carefully and consult seasoned professionals before advising clients on and through a cooperative conversion. |
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A common question for cooperative partners in a partnership or members in a cooperatively managed LLC is whether such partners or members are also considered employees of the business. As a matter of general law, the two concepts are in opposition. For example, a partner in a partnership and their spouse shall not be deemed to be employees with respect to the partnership.[[236]](#footnote-235) Similarly, in the workers’ compensation context, almost every state, including California, has refused to classify partners as employees absent statutory authority.[[237]](#footnote-236)

The difference between a partner and an employee was illustrated by a case for overtime where the defendant company alleged it did not owe overtime wages because the worker claiming those wages was a partner (and thus, not an employee entitled to wages and overtime). The company argued the worker was a partner because he was interested in and responded to a partnership offer. The court looked beyond the partner label and held that the worker was an employee because he’d never acted as a partner and did not buy any interest in the partnership, exercise managerial discretion, or share in the profits.[[238]](#footnote-237) And conversely, where a contract otherwise appears to be one of employment, a partnership relationship is not created merely because the party to perform the contracted services is to share in a division of the profits of the business as compensation for those services.[[239]](#footnote-238)

California employment law generally follows this rule with some variation. For example, LLCs that are taxed as partnerships are exempt from unemployment insurance tax.[[240]](#footnote-239) Workers’ compensation law allows general partners or “a managing member of a limited liability company” to be excluded from coverage.[[241]](#footnote-240) Because the statutory language is “a managing member” instead of “the managing manager,” more than one manager is envisioned. Thus, a worker cooperative that is democratically controlled should be able to use this option and exclude its worker-owners from coverage.

But the question of employment status within a partnership goes to the larger issue of making labor law compatible with worker cooperatives. In particular, Wheeler v. Hurdman, 825 F.2d 257, supra, is instructive because it distinguishes Goldberg and points out the inadequacy of existing tests for determining employment when applied to a situation of joint ownership (as opposed to a situation of paring out employees from independent contractors). In Wheeler, a general partner brought claims under various federal antidiscrimination laws. Relying on Goldberg, the district court held that the general partner was an employee. The appellate court reversed in a refreshingly extensive and well-reasoned opinion.

While the appellate court agreed that one factor in deciding “ . . . whether an individual is an employee is whether the individual is economically dependent on the business to which he renders service,”[[242]](#footnote-241) it further reasoned that the existing economic realities test did not meet that criteria when the issue of employment involved co-owners because “[i]n the independent contractor cases the essential question was whether or not an individual was part of an enterprise (an employee) or running a separate enterprise. There is no such dividing line here.”[[243]](#footnote-242) The appellate court goes on to note that the presently used tests for determining whether a worker is an employee arise in the context of parsing out employees from independent contractors, and the factors employed in those tests are simply useless for determining the employment status of a worker who is also part owner of a jointly owned enterprise. The following passages from the appellate court in Wheeler explain this problem:

The first difficulty with the many economic reality factors proffered to us is that they largely arise from cases involving alleged independent contractors. The line-drawing exercise in those cases was between those who were really part of a business (employees) and those who were running a separate business (independent contractors). Factors employed for that purpose are useless for drawing lines between people who are part of the same enterprise.[[244]](#footnote-243)

The second difficulty with the proffered tests is that they purport to, but in fact do not, encompass reasonable limits. We are assured that these tests would not result in every partner falling under the Acts. Size is suggested to be an underlying criterion, presumably because according to Wheeler, “[b]eing a ‘partner’ in a four-partner firm is significantly different than being a ‘partner’ in a 500+ partner firm. The economic realities are markedly different.” That is not necessarily so. The heart of the standard proposed to us is a theory that any individual who is organizationally or economically dominated is an employee. In applying the domination theory to partnerships, there is an underlying assumption by its proponents that a “true” general partnership operates like a New England town meeting; that “true” general partners are not employees because they personally control management of the business and their own affairs within the business; that “true” general partners are not “dominated;” they are not controlled; they enjoy equality of bargaining power. Presumably, a “true” partner is not only heard at partnership meetings but actually controls the result as it affects that partner. With due respect, those arguments and assumptions are not likely to translate to the real world with any discernible limits.[[245]](#footnote-244)

In another case that also involved a worker cooperative that was characterized as a “closely-knit partnership” and “an unincorporated association,” Wirtz v. Construction Survey Cooperative, the court both distinguished Goldberg and reflected the reasoning of Hurdman. The question in Wirtz was whether the members of the cooperative were employees and thus subject to FLSA overtime and record-keeping provisions. The cooperative at issue in Wirtz was founded in reaction to the conditions that existed during the Great Depression of the 1930s:

In an attempt to provide an improved standard of living for himself and a few others, he embraced the principles of the cooperative movement which, in effect, is the name used to designate those forms of economic activity in which organized groups own and operate business enterprises for the mutual benefit of their members. At the outset, therefore, it must be noted that the economic base which supports the cooperative structure, as Szmak visualized it, was antithetical to the wage and hour system of production which the Act was designed to control. United States v. Darby, 312 U.S. 100, 109, 61 S.Ct. 451, 85 L.Ed. 609 (1941).[[246]](#footnote-245)

The Wirtz court engaged in a factual inquiry of the entire operational arrangement, instead of making a legal conclusion based on the choice of entity. Although worker cooperative principles were not discussed, as seen below, the members engaged in an informal cooperative structure of control and distribution of earnings. The court held that the members were not employees and in so doing, put Goldberg in perspective.

No traditional, mechanical application of the usual tests to determine the employment relationship will suffice; rather, the Court is required to sift the linguistic chaff of labels and scrutinize the kernel of the ‘economic realities’ of the situation. United States v. Silk, 331 U.S. 704, 713, 67 S.Ct. 1463 (1947).

Thus, protection of the Act should be given if the Court reasonably may adjudge an employment relationship. Initially, it must be noted that members of a cooperative may also be employees of the cooperative within the Act.  Goldberg v. Whitaker House Cooperative, supra; Farmers Reservoir & Irrigation Co. v. McComb, 337 U.S. 755, 69 S.Ct. 1274, 93 L.Ed. 1672 (1949). On the other hand, if the cooperative were genuinely synallagmatic, no employer-employee relationship can exist and the Act is not applicable. 29 U.S.C.A. § 206; Walling v. Portland Terminal Co., 330 U.S. 148, 152, 67 S.Ct. 639 (1946); United States v. Darby, 312 U.S. 100, 61 S.Ct. 451 (1941). Applying the facts of the instant case to the relevant legal rules and authorities, the Court finds that the Act should not be applied to the defendants. The Cooperative lacks all the indicia of an employment situation, and the Court finds no factual basis to conclude that the persons involved require the protection of the Act. The members of the Cooperative constitute a small, closely-knit partnership of intelligent technicians, working together as a unit to improve their economic lot as a unit. It was not organized to avoid the application of the Act but existed in the same form long before the Act. The members are not regimented and conduct themselves as self-employed, independent craftsmen. They come and go as they please and work or not work at will. No corporate structure is involved and the Cooperative has no officers, officials or board of directors. All the members share the losses as well as the profits on a monthly basis. No member receives a salary; the terms of remuneration are determined by vote of the entire membership. No one may be expelled. Each member has an equal voice in management and unanimous consent is necessary on all decisions. A member may sell his services to an outside employer and yet remain a member of the Cooperative, receiving compensation on his labor investment for any work he may perform in the Cooperative. Any member may resign and thereafter join the Cooperative without restriction, or penalty.[[247]](#footnote-246)

The Wirtz court agreed with Goldberg that members in a cooperative can be employees of the cooperative. But Wirtz held that, under the facts of the case, the worker-owner members were not also employees. Wirtz has neither been followed nor criticized by any subsequent case and therefore must stand on its particular facts. But that is exactly the point, as demonstrated in Wirtz: the determination of whether a cooperative member is also an employee of that cooperative should be a question of fact and not a question of law based solely on the company’s choice of entity.

#### Corporations

Under current employment law, in almost every situation, a person who provides services to a cooperative corporation in exchange for compensation will be considered an employee subject to statutory exceptions. This automatic conclusion is seen in the Goldberg case, detailed below, which stands for the proposition that worker cooperative members can also be employees of the cooperative. More recently, the court in Clackamus (also detailed below) looked beyond the entity status in determining whether members of a professional corporation were employees based on a factual inquiry. While the Clackamus analysis has been applied to a number of other corporate entity types, it has yet to be applied to worker cooperatives. Hopefully, these two cases represent both the past and the future for how courts determine whether members of a worker cooperative are also employees of that cooperative.

***Goldberg v. Whitaker House Cooperative, Inc.*, 366 U.S. 28 (1961)**

Although the Goldberg court did not explicitly state that the cooperative in question was a cooperative corporation, it probably was; there is an “Inc.” in the name, and the court said that it “... was organized in 1957 under the laws of Maine; and we assume it was legally organized.” Nothing more is said in Goldberg about the entity status. A wage order particular to this industry was used to determine who is an employee. The question in Goldberg was whether the members of the cooperative were employees of the cooperative under the FLSA.

The cooperative members were two hundred embroidery workers who worked from home. There was a manager and a few employees who engaged in the finished work. After an intense factual analysis of the operation, membership, and distribution of earnings, the court held that the members were employees of the cooperative:

There is no reason in logic why these members may not be employees. There is nothing inherently inconsistent between the coexistence of a proprietary and an employment relationship. If members of a trade union bought stock in their corporate employer, they would not cease to be employees within the conception of this Act. For the corporation would “suffer or permit” them to work whether or not they owned one share of stock or none or many. We fail to see why a member of a cooperative may not also be an employee of the cooperative. In this case the members seem to us to be both “members” and “employees.” It is the cooperative that is affording them “the opportunity to work, and paying them for it,” to use the words of Judge Aldrich, dissenting below. [275 F.2d at page 366.](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1960112614&pubNum=350&originatingDoc=I616c31619c1f11d9bc61beebb95be672&refType=RP&fi=co_pp_sp_350_366&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)#co_pp_sp_350_366) However immediate or remote their right to “excess receipts” may be,12 they work in the same way as they would if they had an individual proprietor as their employer.13 The members are not self-employed; nor are they independent, selling their products on the market for whatever price they can command. They are regimented under one organization, manufacturing what the organization desires and receiving the compensation the organization dictates.14 Apart from formal differences, they are engaged in the same work they would be doing whatever the outlet for their products. The management fixes the piece rates at which they work; the management can expel them for substandard work or for failure to obey the regulations. The management, in other words, can hire or fire the homeworkers. Apart from the other considerations we have mentioned, these powers make the device of the **cooperative** too transparent to survive the statutory definition of “employ” and the Regulations governing homework. In short, if the “economic reality” rather than “technical concepts” is to be the test of employment [citation] these homeworkers are employees.”[[248]](#footnote-247)

The Goldberg opinion reveals what is wrong with employment law as it is currently applied to worker cooperatives. The court’s factual examination shows pretty clearly that whatever entity was before the court, it was not operating as a worker cooperative. There was not even the hint of democratic control or patronage distributions. The Goldberg court did not make any attempt to define a worker cooperative or determine whether the entity before it comported with any such definition. And yet it is this case that is used as the standard and precedent for holding that worker-members of cooperative corporations are employees. The absence of any definition of a worker cooperative allowed the court to reach the conclusion that there is no difference between a worker/co-owner who receives a distribution based on patronage and a worker who buys stock in their corporate employer. The court also noted that the members “are not self-employed; nor are they independent,” two considerations that are contrary and irrelevant to a business owned and managed by its workers. The finding that the members could be hired and fired also conflicts with the structure of worker cooperatives because employment in a cooperative is tied to membership, and the termination of membership requires due process (see the “Wrongful Termination” section below). In short, Goldberg should not be the standard for determining employment relationships in worker cooperatives because the business entity in Goldberg was neither structured nor operating as a worker-owned-and-managed cooperative.

Yet Goldberg, unfortunately, is the standard and applied like a mantra, without a factual analysis of the entity structure or its members’ shared efforts, profits, and decision-making. Consider, for example, an opinion letter from the Wage and Hour Division of the U.S. Department of Labor, where members of a cooperative grocery store stocked shelves, swept floors, worked the cash register, and so forth in exchange for discounts on groceries. The opinion letter held that under the FLSA’s “suffer or permit to work” standard, these members were employed, and because their services were rendered for private and not public objectives (which might have classified them as volunteers), they were employees. The legal analysis in support of the opinion went no farther than repeating the Goldberg mantra that members of worker cooperatives can also be employees.[[249]](#footnote-248)

***Clackamas Gastroenterology Assocs., P.C. v. Wells*, 538 US 440 (2003)**

The supreme court in Clackamas articulated the standard for determining whether a shareholder of a professional corporation is an employee for purposes of the Americans with Disabilities Act (ADA). The court refused to apply the bright line rule adopted by the court of appeal that shareholder-directors are employees and instead devised a six-factor test that was influenced by the Restatement’s definition of master-servant but focused on the common law element of control. While this six-factor test is a bit more relevant to worker cooperatives than other tests, it still misses the mark because it defines employment in the context of a professional corporation where the work is done independently by professionals serving their respective clients, who have an active role in running the business, instead of worker-owners who work together in joint pursuits. While many worker cooperatives could be similarly situated if they are small businesses and the members exercise considerable judgment and discretion, and the Clackamas decision does, thankfully, put substance over form, it still falls short in providing a formula for determining employment status for worker cooperative members because it is based on the employment of individuals instead of joint worker-owners. It is a step in the right direction that deserves further steps.

But what is important is that the court set the groundwork for a fact-based test to determine employment status within a worker cooperative. The court said that a particular title such as partner or director should not dictate employment status.[[250]](#footnote-249) Nor should the type of entity dictate employment status, because there are partnerships with hundreds of members.[[251]](#footnote-250) Rather, the focus should be on the worker’s true power and influence within the organization. There is no determination of employment status for shareholder-directors per se, and each case “must be considered on the merits” without resorting to a “shorthand formula or magic phrase.”[[252]](#footnote-251)

The Clackamas formula has been applied to a number of situations. For example the Feldman court chose to use the Clackamas test instead of another test that weighed factors for determining independent contractor status as “not particularly germane to an analysis of the relationship between a shareholder-director and his or her professional corporation.”[[253]](#footnote-252) Also applying the Clackamas formula, the Bluestein court found that the right to cast a vote equal to any other board member indicated the absence of an employment relationship.[[254]](#footnote-253) In line with Clackamas, the Bluestein court refused to determine employment status based upon the entity status noting that there are partnerships with hundreds of members. The court held that the claimant was not an employee and instead was “a full partner, shareholder” because she had an equal vote on the board, shared in the profits, and had a meaningful role in the operation of a small professional corporation. Similarly, the Smith court held that restaurant co-owners were not employees under Clackamas.[[255]](#footnote-254)

| **→ PRACTICE NOTE:** Attorneys and their cooperative clients should be aware that in determining either worker-owners of a jointly owned and managed entity, size matters. The legal determinations of employment status in their cooperative could turn on whether *each* of its member-owners continues to have a *meaningful role* (not a *pro forma* role) in managing and operating the business, and share in profits on an equitable basis. While your clients might find it tempting for one person in the cooperative to take on office or management roles while other worker-owners do the client work, this kind of segregation from ongoing operations-level decision-making, and the strategy and visioning work, makes the operation look more like an employment situation and less like a co-ownership of a business situation. Ongoing democracy-in-fact within an operating cooperative is just as important as the structural democracy that a lawyer can build into it, via entity choice and foundational legal documents. Under *Clackamas*, a business run by a *few* peoplewho *each* have a *meaningful role in its operation* and *share in its profits* on an equitable basis, like patronage, should *not* be found to be employees of the cooperative, regardless of the choice of entity. |
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The Clackamas formula also points to an operational advantage of worker cooperatives due to their all-hands-on-deck approach. For example, a worker cooperative in a building trade might often have fewer than ten people and could give each member executive responsibility in addition to membership. One member could be responsible for estimating and bidding, another for contracts, another for equipment, and so forth. Compare this with a typical small business where one or only a few people (who are not worker-owners) manage all aspects of the business and stand to directly benefit from their business ownership. All things being equal the cooperative can be better positioned to distribute the work, operate efficiently, and compete in the open market.

### Wage and Hour Law

California wage and hour claims are governed by two complementary and occasionally overlapping sources of authority: the Labor Code provisions, enacted by the legislature, and a series of eighteen wage orders, adopted by the IWC.[[256]](#footnote-255) The remedial purpose of California laws regulating wages, hours, and working conditions is to protect employees.[[257]](#footnote-256) Many of the same protections are provided by the Federal Fair Labor Standard Act (FLSA), which applies to workers in both California and other states. The FLSA is considered proper authority in California courts, but if there is a conflict, California law will prevail.[[258]](#footnote-257) Courts in California should construe wage and hour laws with consideration of the purposes they were meant to serve and the type of person they were meant to protect.[[259]](#footnote-258)

The ABC test, which distinguishes employees from independent contractors, is used to determine employee status under the IWC wage orders.[[260]](#footnote-259) It also applies to non-wage order claims that are equivalent or overlapping.[[261]](#footnote-260) But tests to determine employee status in California, and presumably in other jurisdictions, should be applied with due consideration of the purpose of California’s wages and hour statutes and whom they were meant to serve.[[262]](#footnote-261) Unfortunately, employees who are also employers have not been distinguished by these statutes.

This section will examine both the wage and hour issues that apply to all businesses (including worker cooperatives) and the issues that are particular to worker cooperatives.

#### Wage and Hour Issues Applicable to All Businesses

Under the current law in California, members of worker cooperatives formed as corporations will be deemed to be employees, and the cooperative’s failure to comply with wage and hour laws could make it liable for monetary assessments and penalties. The opposite will most likely be the case with worker cooperatives that are formed as LLCs.

| **→ PRACTICE NOTE:** IWC wage orders applicable to your client’s particular business should be reviewed to determine both employment status and wage and hour requirements. |
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#### Wage Rate

California’s laws regulating working hours are contained in [Labor Code sections 510](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS510&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)) to [556](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS556&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)) and [1171](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS1171&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)) to [1205](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS1205&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)).[[263]](#footnote-262) The IWC’s applicable wage order defines the employment relationship and who may be liable for unpaid minimum wages.[[264]](#footnote-263) Unless employees fall within one of the state and federal law exemptions[[265]](#footnote-264) to the overtime requirements, the duty to pay overtime wages is clear and is a well-established fundamental public policy affecting the broad public interest.[[266]](#footnote-265) It fosters a society’s interest in a stable job market.[[267]](#footnote-266) So does the creation of worker cooperatives according to the U.S. Congress.

Every hour of work that exceeds eight hours in a workday, or forty hours in a workweek, must be paid to each nonexempt employee at an overtime rate set by statute.[[268]](#footnote-267) There are regulations regarding working hours for specific occupations.[[269]](#footnote-268) “[H]ours worked” includes time during which the employee is subject to the control of the employer, or is permitted to work, whether requested to work or not.[[270]](#footnote-269)

| **→ PRACTICE NOTE:** Note that there are separate provisions for alternative work schedules set forth in Labor Code sections 511, 514, and 554.[[271]](#footnote-270) Because in worker cooperatives, the workers can control the work environment, cooperatives may be in a better position than other businesses to create their own alternative work schedules as provided by the regulations. Also be sure to confirm with your cooperative clients who have employees that each employee is properly classified as either “exempt” or “nonexempt” from the overtime laws, complying with both the minimum salary and in their job duties to qualify for an exemption. The most common exemptions are the Executive, Administrative, and Professional exemptions and the exemption for Computer and Outside Sales employees. The California Department of Industrial Relations details the state law exemptions at <https://www.dir.ca.gov/dlse/faq_overtimeexemptions.htm>. The federal law exemptions are found at 29 C.F.R. Part 541—Overtime Exemption Regulations for Executive, Administrative, Professional, Computer and Outside Sales Employees. |
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#### Rest and Meal Breaks

An employer is prohibited from making an employee work during a rest or meal break mandated by IWC wage orders. Under Labor Code section 226.7(a), a thirty-minute meal break is required for every five hours of work, and a rest period of ten minutes for every four hours of work.[[272]](#footnote-271) An hour’s pay must be paid for every rest and meal break that was not provided to the employee. Under Labor Code section 226.7(a), these payments are considered wages for statute of limitations purposes.[[273]](#footnote-272)

The employer is not obligated to police meal breaks to ensure that no work is performed during a meal break. Instead, bona fide relief from duty and the relinquishing of control satisfies the employer’s obligations.[[274]](#footnote-273) An employer was found to meet this standard where the evidence showed that the employees were (1) aware of their right to take meal breaks; (2) never denied off-duty meal periods; (3) always received meal breaks when requested; and (4) those employees who did not enter into a meal period agreement were paid for one hour.[[275]](#footnote-274)

Similarly, California law does not require an employer to ensure that employees take rest periods. An employer need only make rest periods available[[276]](#footnote-275) and is liable only if it does not permit rest periods.[[277]](#footnote-276)

| **→ PRACTICE NOTE:** Attorneys and clients alike should be aware that making claims against employers for failure to comply with rest and meal breaks has become a cottage industry for some law firms. So, it’s important for worker cooperatives to understand and comply with meal and rest break requirements, preferably in a way that documents compliance. Note also that a recent California Supreme Court decision has dampened some enthusiasm by holding that attorney fees could not be awarded in claims for lost rest breaks.[[278]](#footnote-277) |
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Although employers, including worker cooperatives, are not required to keep records of rest breaks,[[279]](#footnote-278) it is highly recommended that employers do so. Worker cooperatives are no less vulnerable to this liability than other businesses even if the workers run the business.[[280]](#footnote-279) A worker claiming that he or she was not provided breaks for some years could easily amount into a six-figure liability. This liability is further enhanced by the burden of proof scheme in support of a claim for not providing breaks: while the worker has the initial burden of proving the absence of breaks, if the employer’s records are inadequate, this burden is met by sufficient evidence showing time worked without breaks.[[281]](#footnote-280) Oral testimony without records will do, so long as it is sufficiently credible and adequate.[[282]](#footnote-281) If the employee meets this burden, the employer must produce precise evidence to the contrary.[[283]](#footnote-282)

| **→ PRACTICE NOTE:** Worker co-ops should be strongly advised to have a system in place (an easy and quick electronic system) that keeps track of the hours worked and breaks taken by all nonexempt employees, whether or not the employees are members of the cooperative. The data should be submitted by each worker, at least daily, as part of the regular work routine. But note that tracking meal and rest periods should not be done *during* those periods, because the worker must be “relieved of all duties” during their meal and rest periods. |
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#### Enforcement of Wage and Hour Claims

The Division of Labor Standards Enforcement (DLSE), a district or prosecuting attorney, or a wage claimant may institute actions to enforce the wage and hour laws.[[284]](#footnote-283) The DLSE may prosecute such a civil action without or without the consent of the affected employees.[[285]](#footnote-284) But the legislative intent is that such actions should be brought by the affected worker.[[286]](#footnote-285) Workers who choose to make such claims can either file a civil action or an administrative action known as a “Berman” hearing. [[287]](#footnote-286)

#### Wage and Hour Issues Particular to Worker Cooperatives

**Sweat Equity and the Case of Godoy v. Restaurant Opportunity Center of New York, Inc.**

The Godoy case presents a cautionary tale concerning sweat equity invested in the formation of a worker cooperative and the need to consider the business side of worker cooperatives when determining employment status.[[288]](#footnote-287) The particular question addressed is whether the time worked in contributing sweat equity toward the formation of a worker cooperative entitles a member to a wage when the member does not receive the promised equity once the cooperative is formed. Plaintiffs were restaurant workers and members of a nonprofit corporation, the Restaurant Opportunity Center of New York (ROC–NY), which received publicity in the New York Times and People magazine. Several months later, ROC–NY began seeking grants to launch what was described as a “cooperatively owned restaurant” and told members, including plaintiffs, that cooperative committee members would become owners of the new restaurant in return for doing one hundred hours of work, which was described as “sweat equity.” But when the demand for work increased beyond the original one hundred hours, plaintiffs began to question whether a real cooperative was being formed. In response to further demands for service, plaintiffs withdrew from the group forming the cooperative. When the restaurant was later opened, and plaintiffs did not receive any equity for their services, they filed a civil action alleging “back pay” under the FLSA (and other causes of action for breach of contract and fraud, which were not addressed by the court).

Under these facts the *Godoy* court found that plaintiffs were not employees, but rather had engaged in a contractual exchange for equity ownership. It also found that under the FLSA’s economic realities test, the workers’ laboring for and together with a not-for-profit corporation toward the co-ownership of a business was closer to a partnership of putative co-owners than to a putative employment relationship. “Like partners at a firm, Plaintiffs, as putative co-owners of the business they were working to create, assume[d] the risks of loss and liabilities” of the venture and had a real opportunity to share in its profits upon success. Plaintiffs’ hours of sweat equity represented their capital contribution to the business.[[289]](#footnote-288)

| **→ PRACTICE NOTE:**  The court’s holding that the relationship of the parties was contractual and not one of employment is instructive because it shows that the preformation relationship is controlled by a contract, and worker cooperatives can use contracts to create economic relationships where statutory law does not exist. But it also shows that there should be a clear meeting of the minds by those providing start-up services for a worker cooperative on issues such as the contributions required in the formation of the business, a process for reevaluation and reformulation as start-up needs and services change, and any contractual compensation that may be due to those who provided services but do not become members. The larger issue of compensating founding members of worker cooperatives who provided start-up services is another issue in need of resolution. But the weighted hours approach, suggested in the section below discussing permitted discrimination in favor of founders, may be an interim solution until there is a better one. |
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The Godoy court further held that sweat equity is not wages and the two are facially incongruous. Equity, sweat or otherwise, refers to a right or interest in property or a business, while wages are compensation due for service but do not create a right in equity. The court’s decision is not only noteworthy for addressing worker cooperative sweat equity but for defining the employment relationship by looking at the economic realities of the business side of cooperatives, not the working relationship between the cooperative and its workers. The Godoy court at footnote 5 says that the Goldberg case was “readily distinguishable.” As such the Godoy court found the cooperative in formation to be like a partnership of co-owners.

| **→ PRACTICE NOTE:**  Practitioners should note that *Godoy* may apply only to characterize sweat equity earnings contributed *before* a cooperative is incorporated. If the sweat equity is contributed *after* incorporation, courts would likely consider only the working relationship in deciding how to characterize those earnings and the worker’s employment status, without regard to the business relationship between the cooperative and its worker-owners. Future tests really should take both into consideration to create a well-reasoned body of case law for worker-owned cooperatives. |
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#### Are Patronage Dividends Wages?

State agencies seeking funding for their employment departments say “yes,” but the IRS says “no” and taxes the patronage dividends received by members of a worker cooperative as self-employment income.[[290]](#footnote-289) Given these polar opposite positions, the same patronage distribution could be taxed by a state unemployment insurance agency as a wage and taxed again by the IRS as business income. First consider the IRS.

The IRS has long distinguished income and wages as district concepts. The former is treated expansively and the latter “narrow and precise.”[[291]](#footnote-290) A U.S. Department of Justice memo from the Chief Counsel to the Assistant Attorney General Tax Division discussed a worker cooperative’s attempt to reduce taxes by declaring as wages all the compensation it paid to its members and then deducting the wages as a cost of doing business under IRC section 162. The cooperative could not use the deduction found in subchapter T of the IRC because distributions were not fixed with reference to the net earnings of the cooperative under IRC section 1382(b). The memo stated that only a reasonable amount of compensation comparable to similar workers should be deemed wages, and any amount above is “disguised dividends” because “… member-workers to whom wage payments are made have a dual capacity with respect to the labor performed for the organization.” Members work in both “their capacity as patrons in which they share in the fruits of their labor and they also work as employees of the cooperative. Business performed with a cooperative in such a dual capacity is not inconsistent with cooperative principles.” [[292]](#footnote-291)

A memo from an Assistant Chief of an interpretive division to the Director of Refund Litigation reached a similar conclusion:

In G.C.M. 18889, \*\*\* A-306412 (July 23, 1937), this Division took the position that an employer-employee relationship can exist between a worker-owned cooperative and its member-worker. Therefore, we concluded that for purposes of the taxes imposed under the Social Security Act, a member-worker could, depending on the facts and circumstances, receive wages from the cooperative. In O.M. 18170, \*\*\*, I-293-74 (April 1, 1975), which relied upon the conclusion reached in [G.C.M. 18889](http://www.westlaw.com/Link/Document/FullText?findType=Y&pubNum=3002&cite=GCM18889&originatingDoc=I76f983fae20111dbb92c924f6a2d2928&refType=CA&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Search)), this Division took the view that payments made to member-workers by a worker-owned cooperative may be characterized as wages deductible under [section 162](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1012823&cite=26USCAS162&originatingDoc=I76f983fae20111dbb92c924f6a2d2928&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Search)) rather than as advance patronage dividends. However, in O.M. 18782, \*\*\* I-293-74 (March 23, 1977), we stated that bi-monthly payments to member-workers of a worker-owned plywood cooperative cannot be characterized as wages, and must be deemed to be advances against patronage dividends. We argued that under cooperative principles member-workers have an identity of interest with their cooperative since they are the cooperative. Therefore, we concluded that no employer-employee relationship can exist between the cooperative and its members. For the reasons set forth below, it is now our opinion that the position originally postulated in O.M. 18170 is correct. We believe that the dual status of a member of a worker-owned cooperative as both an owner and employee of the cooperative is analogous to the status of the principal stockholder of a closely-held corporation who is also the principal officer of the corporation and receives a substantial salary for his services as an officer.[[293]](#footnote-292)

A 1994 Field Service Advisory opinion similarly addressed the question of whether patronage dividends are subject to self-employment taxes in consideration of the “… workers’ dual capacity as patrons and employees of the cooperative.” It concluded that the proper characterization of patronage dividends is net earnings rather than wages in light of “the historical purpose, goals and income tax of cooperatives.” In reaching this conclusion, the opinion distinguished worker cooperatives from other forms of business:

The basic and distinguishing feature of a workers cooperative association, as compared with a corporation-for-profit, is that in the case the case of a workers cooperative association the fruits and increases which the worker-members produce through their joint efforts are vested in and retained by the workers themselves, rather than in and by the association, as such, which functions only as an instrumentality for the benefit of the workers; and that these fruits and increases of the cooperative effort are then allocated among the active workers as patronage dividends, in proportion to their participation in producing the same. In the case of the corporation-for-profit, on the other hand, the fruits and increases of such organization belong to the corporate entity itself; and these increases (called net profits) are then either distributed or retained for the benefit of the equity owners, not in proportion to their personal efforts but rather in proportion to the amounts of capital which they supply. And also these same equity owners, acting either directly or indirectly, also select the management and control the functions and policies of their entity—not on a one-person one-vote basis without use of proxies, but rather through multiple voting in proportion to the number of shares of capital stock which they hold.[[294]](#footnote-293)

In 2019 the IRS issued proposed rules concerning patronage dividends based on the premise that “… patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron, and are tested by the Cooperative at its trade or business level.” Under the proposed regulations, patronage dividends would be included in a patron’s “QBI,” which is a net amount of qualified items of income, gain, deduction, and loss, with regard to business income.[[295]](#footnote-294) In other words, it is part of a member’s business income.

In spite of the consistent position taken by the IRS that patronage dividends are not wages, an Oregon appellate court came to the opposite conclusion.[[296]](#footnote-295) The Saif case involved a worker-owner with a claim for workers’ compensation benefits. The legal question was whether patronage dividends were wages in calculating those benefits. The cooperative was a corporation formed under Oregon’s worker cooperative statute (ORS chapter 62). The Administrative Law Judge held that all of the patronage dividends were part of the member’s wages. The appellate court agreed, citing “the nature of the cooperative” and Oregon’s statutes, which broadly define wages:

Based on the definition of “wages” in [ORS 656.005(29)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.005&originatingDoc=I08478e0df55611d99439b076ef9ec4de&refType=SP&originationContext=document&transitionType=DocumentItem&contextData=(sc.DocLink)#co_pp_4c1800008e0b0) and the nature of the cooperative of which claimant was a member, we are persuaded that the patronage dividends that claimant received were wages. As the Supreme Court explained in *Linnton,* the income produced by a cooperative through the efforts of its members is properly considered the income of the members, rather than the profits of the cooperative. Coupled with the fact that the patronage dividends were based on the hours that claimant worked, that feature of a cooperative disposes of [the] employer’s argument that claimant’s entitlement to patronage dividends was comparable to a stockholder’s right to share in a corporation’s profits. Furthermore, the fact that the dividends were monetary and based in part on the number of hours that claimant worked means that the dividends were properly considered a “money rate.” It also is significant that claimant was entitled to the patronage dividends under the membership agreement that she signed when she became a member of Burley. Thus, the dividends were part of “the money rate at which the service rendered is recompensed under the contract of hiring.” [ORS 656.005(29)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.005&originatingDoc=I08478e0df55611d99439b076ef9ec4de&refType=SP&originationContext=document&transitionType=DocumentItem&contextData=(sc.DocLink)#co_pp_4c1800008e0b0). Because patronage dividends fall under the statute’s basic definition of “wages,” there is no need to analyze the extent to which they qualify as a “similar advantage” under [ORS 656.005(29)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.005&originatingDoc=I08478e0df55611d99439b076ef9ec4de&refType=SP&originationContext=document&transitionType=DocumentItem&contextData=(sc.DocLink)#co_pp_4c1800008e0b0).[[297]](#footnote-296)

Obviously, the IRS and the appellate court in Oregon cannot both be right. These opposite opinions on the same matter not only highlight the confusion over the characterization of patronage dividends but also exemplify the larger problem of existing employment law applied to worker cooperatives. Arguably, the IRS has the better-reasoned position. Worker co-op members receive wages just like other nonmember employees who work for the cooperative. These wage payments are guaranteed by statute for members and nonmember workers alike. The difference is that member workers also receive an apportioned share of the net earnings in the form of patronage dividends.[[298]](#footnote-297) Like other business income, it is not guaranteed, and importantly, if the cooperative loses money, members proportionally share the loss. While the hours of employment may be used to determine the amount of patronage to be distributed, the hours worked do not create the right to patronage dividends. Dividends are the result of co-ownership and co-operation of a business. These benefits and risks do not exist in standard employment relationships enshrined in employment law that looks no further than services rendered in exchange for an hourly wage or salary.

| **→ PRACTICE NOTE:** Because of the confusion demonstrated by the contrary positions of federal and state taxing agencies, worker cooperatives should not be expected to know whether patronage dividends are properly characterized as wages or dividends. Hopefully in the future, comprehensive worker cooperative statutory and/or case law will resolve the contradiction. In the meantime, worker cooperatives may have to decide whether to treat patronage as dividends or wages. While this section cannot provide any advice beyond consulting a knowledgeable attorney and/or accountant that will help the cooperative weigh the legal risks before making this decision, if a worker cooperative chooses to treat patronage distributions as dividends and not wages, the positions presented by the IRS could provide a defense to any legal challenge by showing that the cooperative acted in good faith based on meritorious legal grounds. |
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### Unemployment Insurance

The purpose of the California Unemployment Insurance Code (CUIC) is to provide benefits to people who become involuntarily unemployed through no fault of their own.[[299]](#footnote-298) As remedial legislation, it should be “liberally construed to afford all relief which the Legislature intended to grant” consistent with the plain language of the statutes.[[300]](#footnote-299) It is legislation that imposes taxes, and the taxing section of the legislation is separate from those concerning benefits.[[301]](#footnote-300) The employer/employee relationship determines who pays taxes to the unemployment and disability funds.[[302]](#footnote-301) The following discussion will focus on when (and for which workers) a worker cooperative must pay unemployment insurance taxes, because there is an employer/employee relationship between the worker-owners and the cooperative.

The CUIC has adopted the ABC test for defining an employment relationship. CUIC section 621(b) was amended effective January 2, 2020, to provide that any individual providing labor or services for remuneration has the status of an employee rather than an independent contractor, unless the hiring entity demonstrates all of the following: The individual (1) is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact (2) performs work that is outside the usual course of the hiring entity’s business and (3) is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

However, it’s worth noting that the regulation to CUIC sections 621(b) and 13020 appears to rely on the common law test, which first seeks to determine an employment relationship on the basis of control, and if that cannot be accomplished, secondary considerations are considered.[[303]](#footnote-302) While this regulation may be out of date given the recent amendment to section 621, its purpose is “… to promote an accurate and *fair determination of employment status*, by allowing a comprehensive analysis *of all the relevant facts*” (emphasis added).[[304]](#footnote-303) But again, it should be noted that this regulatory definition, along with section 621, is intended to distinguish employees from independent contractors (and does not contemplate the status of worker-owners in a cooperative).

There are some statutory exceptions for workers who provide certain specific services. For example, there is a rebuttable presumption that services provided by attorneys, physicians and surgeons (including osteopathic physicians and surgeons), dentists, engineers, architects, accountants, and the various types of physical, chemical, natural, and biological scientists are rendered as independent contractors.[[305]](#footnote-304) Various specific occupations are also exempt by statute.[[306]](#footnote-305) Directors of corporations acting in their capacity as directors are not employees.[[307]](#footnote-306) While this exemption should apply to directors of worker cooperatives without distinction, currently California’s unemployment insurance law does not address the role of members of worker cooperatives in operating their business, either as ultimate decision-makers by their member vote or acting as an executive of the worker cooperative.

Importantly, however, there are exemptions that could apply to worker cooperatives, because, unlike other workers, worker-owners own and operate the business for which they provide services. For example, an individual is not an employee if he or she has a substantial investment in facilities used in connection with the performance of the services in question, other than in facilities for transportation, or if the services are in the nature of a single transaction not part of a continuing relationship with the employing unit.[[308]](#footnote-307) There is no case law interpreting section 621 subdivision (c)(2). But given the clear language, “substantial investment in facilities used in connection with performance in question,” members of a worker cooperative could be exempt under the following possible scenarios: (1) the membership fees, and any subsequent member contributions, are used to purchase the real property where the cooperative conducts its business or to purchase equipment for the cooperative; (2) members provide to the cooperative equipment they own to perform the work of the cooperative (this could occur in a cooperative involved in the building trades); or (3) a worker cooperative purchases the real property where the cooperative conducts its business by creating a limited partnership whereby the cooperative is the general partner, and the individual members of the cooperative, as well as investors who are not cooperative members, are limited partners who collectively would have most of the ownership interest in the property. Noteworthy here is that worker cooperatives can secure their property through outside investment while the cooperative maintains control. And the outside investors, and cooperative members who want to invest, would get, as a return on their investment, both capital appreciation and rental income. This could be a “win-win” setup based on the law and the economic realities.

| **→ PRACTICE NOTE:** Any determination of this exemption would involve a question of both law and fact. The legal question is whether there was an investment as envisioned by the law. The factual question is whether it was substantial. If this subsection can be utilized by worker cooperatives, it could give them added motivation to purchase the property where they conduct their business. Another exemption applies to worker cooperatives that are formed as an LLC and elect to be treated as a *partnership* for federal income tax purposes.[[309]](#footnote-308) However, this exemption will not apply if the LLC files a *corporate* federal tax return.[[310]](#footnote-309) |
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There is only limited case law where the employment status of worker-owner members of a cooperative was at issue in the unemployment insurance context. The following five cases are instructive for both what they say and what they do not say.

***California Employment Commission v. Butte County Rice Growers Ass’n***

In this case the unemployment insurance commission sought payment of premiums for seasonal employees who worked for a marketing cooperative incorporated in 1914 as a cooperative association under laws providing for a nonprofit farmers’ organization. The cooperative association had forty-eight members. Although the issue before the court was an exemption for agricultural workers, and it did not delve into the employment status of these workers, it did lay down certain markers applicable to worker cooperatives. The workers in this case were subject to the control of the corporate entity.[[311]](#footnote-310) The court noted that a cooperative is a legal entity distinct from its members whose employees need the protection. And continuing this line of thought, “[t]he nature of the defendant’s corporate structure is immaterial for cooperative corporations \* \* \* are just as distinct an entity as are other private corporations” (emphasis added).[[312]](#footnote-311) The dissent noted the peculiar relationship between the cooperative association and its members as principals and agents.[[313]](#footnote-312) Given that this case was decided in 1945, it’s important to note that the California Cooperative Corporation Code section 12200 et seq. and subchapter T of the Internal Revenue Code were both enacted after this decision and do not align with the court’s observation about cooperatives.

Worker cooperatives should not have a problem with this decision to the extent it holds that nonmember workers are employees of the cooperative under the Unemployment Insurance Act. But this case should not be precedent for the employment status of member workers.

### **California Employment Stabilization Commission v. Sacramento Valley Walnut Ass’n**

In this case “contributions” (taxes) were sought from a marketing cooperative of walnut growers whose members were limited to walnut growers. The case concerned an assessment of one member who was a director and represented the cooperative at business meetings for a cooperative central organization (similar to what is provided by California Cooperative Corporation Code section 12256) on five different occasions for which he was paid. The marketing cooperative argued that this director was not an employee because he was not on the payroll, not on the insurance, or there wasn’t any other indicia of employment. The court rejected this argument and sought contributions for the compensation he’d received for attending the meetings. The moral of this story is that someone who is not an employee of a marketing cooperative can become one, even for a short duration, when their conduct meets the criteria for employment. This case does highlight a distinction between marketing and worker cooperatives. Whereas in marketing co-ops the income-producing activity occurs in private businesses (e.g., the farms) that join a cooperative to provide a service (marketing) to their members, in worker cooperatives the cooperative is the income-producing entity resulting from the collective work of its members. Thus, the decision has limited precedent value for worker cooperatives. However, the court’s conclusion that “[t]he only thing that can be done is to examine the facts of each case and then determine whether there is present sufficient control and supervision to make one an employee”[[314]](#footnote-313) should also apply to worker cooperatives.

### **Employment Division v. Surata Soy Foods, Inc.**

The Oregon unemployment insurance agency appealed a decision of a referee setting aside an unemployment tax contribution against a worker cooperative. The cooperative had paid unemployment tax for its nonmember employees but not for its six members. The referee had held that Surata was not liable to pay unemployment insurance contributions for the members who performed services for the corporation, finding that the status of the member workers in the cooperative in 1979 “did not include the requisite characteristics of an employee-employer status.” The referee reasoned:

During the tenure of their status as a “member” [sic] any compensation or return for their services was entirely dependent upon there being a savings [profit] from their efforts which could be shared by established rates and in proportion to efforts provided to produce the profit. While no member was never [sic] compensated for their services, this was a distinct possibility and a probability had adverse conditions [not] thwarted the planned results of their cooperative efforts.[[315]](#footnote-314)

The referee, who was the fact finder, made twenty-one findings of fact in support of its decision. Several deserve note:

**No. 5.** These initial five individuals and others who subsequently qualified as members of the cooperative collectively operated as the board of directors and in this capacity elected the corporate officers, who designated the distribution of patronage fees to members and wage scale for non-members, the products and amount to be produced, shift assignments and other business matters, as provided for in their bylaws.

**No. 15.** The members, while acting as the board of directors, determined by mutual consent their work assignments, both duties and amount of hours to be worked.

**No. 16.** Each member performed his or her agreed-upon tasks in the production of the applicant’s products without direction or supervision.

The Surata court overturning the referee’s decision did not dispute any of these findings, and addressing no.16 stated that “… the evidence clearly showed that members worked under the direction of the board of directors as to what shift they would work and what product they would produce.” Without disputing these facts, the Surata court evidently deemed it irrelevant that the cooperative members were all directors and through mutual consent (and not someone else) decided their work assignments. In overturning the referee’s decision, the court focused solely on whether members received compensation for services like other employees. This is an incredible conclusion and, unfortunately, all too typical of the judicial scrutiny given to worker cooperatives. The court held that the referee made an error of law because the case Assoc. Reforestation v. State Workers’ Comp. Bd.,[[316]](#footnote-315) involving members of the Hodad worker cooperative corporation, had become precedent after the referee had made his decision.

In overturning the referee’s decision, the Surata court noted that the legislature’s definition of “remuneration” was broad and should apply equally to worker cooperatives including patronage dividends. Two things said by the court highlight its failure to properly recognize worker cooperative members as business owners and directors (rather than employees). First, the court says, “[W]e see no reason that the recompense that a worker receives for his labor should not be considered remuneration just because the amount varies with the profits of the organization.” Second, members “may be thought of as having a proprietary interest in the cooperative, for the period in which they are members, but this is not inconsistent with what remains in essence an employer-employee relationship.”

The answer to the court’s failure to find reason is that variation in profits is not the result of others (with the workers just lucky recipients) but rather because the worker-owners, who assume the profit or loss of running a business in which they invested their time and money, make the profit through their collective effort. In this court’s poorly reasoned view there is no difference between a member of a worker cooperative who has an active role in running the business and a Google employee who owns Google stock or receives an annual bonus when the company does well.

### **Builders Commonwealth, Inc. v. Thomas**

Builders Commonwealth, Inc. v. Thomas[[317]](#footnote-316) is an unpublished decision that was a footnote to the published decision. In this decision, the cooperative brought an action against a former member seeking a refund of part of a patronage distribution that was made before the cooperative had made any final determination of profit for the year. Under the membership agreement the member had agreed to repay any patronage that exceed the share entitled. In defense, the member claimed that the payments were wages and that a statute forbade making any deductions from wages to satisfy a debt. The court held that the member did not receive wages since the distribution was not earned and instead upheld the right of the cooperative to collect the repayment pursuant to the membership contract.

### **Builders Commonwealth, Inc. v. Dep’t of Employment and Economic Development**

In this case, the cooperative at issue is a realtor whose members engaged in a joint venture and mutual effort on a cooperative basis in the construction, maintenance, renovation, and repair of buildings and other structures; the construction of custom cabinetry; and other custom woodworking projects. Members worked at the job sites or in the cooperative’s shop. According to the membership agreement all members shared both losses and the revenues of the association on a pro rata basis according to work contributed, and the “work value of members may, but need not be equal.” It was the members’ responsibility to provide health and disability insurance and to “… pay self-employment taxes.”

A representative of the Commissioner of Minnesota Department of Jobs and Training decided that there was no employer-employee relationship between the relator and one of its members, and that remuneration paid by the realtor did not constitute “wages'' under Minnesota’s jobs and training law for unemployment tax and benefit purposes. This decision was reversed by an unemployment insurance judge who, following a hearing, apparently determined that there was an employment relationship. When the case was brought before a court, the court acknowledged that it had not previously determined the employment status of worker cooperative members, but in reliance upon Goldberg, stated, “There is nothing inherently inconsistent between the coexistence of a proprietary and an employment relationship. … We fail to see why a member of a cooperative may not also be an employee of the cooperative.”[[318]](#footnote-317) And since Minnesota’s unemployment insurance law gives a broad definition of wages subject to taxation, the court held that there was an employment relationship. The court notes that the Administrative Judge found that the realtor “has the right to control the means and manner of performance of the member/workers” and that the “member/workers do have governance rights as do employees of a corporation who own shares of the corporate stock.” Once again, the court makes no distinction between workers who merely own corporate stock, and workers who own stock and also run the business.[[319]](#footnote-318)

Ironically the court observed that “… the statutes used to differentiate employees from independent contractors for those performing building construction or improvement services, are not on point in this case,” but then the court just went on and used that standard to find an employment relationship. The court first reviewed the issue of control, noting the Administrative Judge had found that the cooperative “has the right to control the means and manner of performance of the member’s work” because the cooperative set the work schedules, work crews, coordinators, and leaders for jobs; made sure work was done satisfactorily; expelled workers for nonperformance; set advance rates; and dealt with grievances and disciplinary matters.[[320]](#footnote-319) The irony is that none of these findings actually support an employment relationship. Rather they show that cooperative members, as a matter of fact, are collectively owning and operating their own business instead of being independent of the same. These findings show responsible business conduct and that the cooperative members have assumed the responsibility of running their own business, not that they are “employees” of the business.

The court’s other finding supporting an employment relationship is equally confusing. It was the right to discharge members by a two-thirds vote “without incurring liability.”[[321]](#footnote-320) Although it’s not clear what this term means, if it is the equivalent to discharge “without cause,” it is contrary to best practices for a worker cooperative’s bylaws.

| **→ PRACTICE NOTE:** Bylaws should set forth grounds and procedure for membership termination. The right to work in a worker cooperative is tied to membership status. It makes no sense for a worker cooperative to have the power to terminate membership without cause. Because membership status only allows a worker cooperative to terminate membership “for cause,” there is an inherent disconnect between a worker cooperative’s obligation to pay unemployment insurance taxes and the ability of its members to collect unemployment insurance benefits (which, as detailed below, are not available to workers terminated for cause). |
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In California a person is not eligible for unemployment benefits if:

… he or she left his or her most recent work voluntarily without good cause or ... has been discharged for misconduct connected with his or her most recent work. An individual is presumed to have been discharged for reasons other than misconduct in connection with his or her work and not to have voluntarily left his or her work without good cause unless his or her employer has given written notice to the contrary to the [EDD] as provided in section 1327, setting forth facts sufficient to overcome the presumption ... [which] ... is rebuttable.[[322]](#footnote-321)

The grounds for terminating an employee or cause are in line with grounds for termination stated in worker cooperative bylaws.[[323]](#footnote-322) If there is a reduction of work, the usual and preferred practice of worker cooperatives is to reduce the work hours of some or all members instead of laying off individual members. A worker cooperative’s bylaws could and should address this reduction-in-available-work situation. Thus, given the legal and operational structure of worker cooperatives, it is highly unlikely, if not impossible, that a member whose employment was interrupted or terminated will be able to collect any unemployment benefits.

And finally, it is worth noting that a “tax statute is void … if it discriminates between persons or property in a like situation or contains classifications that are arbitrary or not based on any reason or that have no fair or substantial relation to the purpose for which it was made.”[[324]](#footnote-323) Whether or not California’s unemployment insurance law is a violation of the Equal Protection Clause of the U.S. Constitution, as applied to worker cooperatives, deserves inquiry. But at a minimum, the Equal Protection Clause indicates a problem that most likely needs to be corrected with legislative action.

#### Unemployment Insurance: Conclusion

In spite of the problems of unemployment law discussed above, worker cooperatives will need to comply with the existing unemployment insurance compensation scheme in California (and in any other state where its workers are working). In California, if the cooperative is a corporation, both the corporation and its members will be subject to taxation, unless the cooperative or its individual members come within one of the statutory exemptions. If the cooperative is an LLC that elects to file a partnership federal tax return, it is exempt. A cooperative that is exempt has the option to come within the unemployment insurance system if certain conditions are met. Even if the cooperative or individual cooperative members contend that they are not workers subject to unemployment insurance taxes, the cooperative must still submit the required filings. The failure to do so could lead to penalties and fines.

Given the above case law, worker cooperatives will probably have to wait until the specific issue of when and how the unemployment insurance scheme should exempt worker-members of a worker cooperative comes before a court of appeal, or beyond, before a court gives careful consideration required for the unique dual roles of worker-owners in a worker cooperative. New, clarifying legislation might also be helpful, as well appellate case decisions based on facts where these dual roles are evident.

| **→ PRACTICE NOTE:** Employers are required to register with the Employment Development Department as prescribed; to keep records of their workers, the wages paid to each worker, and other prescribed information; and to file quarterly reports of contributions and reports of wages paid to workers, including an annual reconciliation return.[[325]](#footnote-324) If the worker cooperative is quitting business or winding up affairs, it will need to file a final report.[[326]](#footnote-325) |
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| **→ PRACTICE NOTE:**  If a cooperative has been assessed a tax that it disputes, and there is neither a statutory exemption nor strong evidence to support the same, the recommended response is to pay the tax (possibly over time) and then bring a refund action in superior court. This has several advantages: (1) the cooperative can bring its case to a “neutral” superior court instead of to the EDD that acts as judge, jury, and court of appeal, in actions where the EDD is a party; and (2) the cooperative can bring other claims in addition to a refund action that could include claims for extraordinary relief such as mandamus or injunctive relief challenging the cooperative’s tax obligation. |
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### Workers’ Compensation

Under California’s workers’ compensation law, the term “employee” means “every person in the service of an employer under any appointment or contract of hire or apprenticeship, express or implied, oral or written, whether lawfully or unlawfully employed.”[[327]](#footnote-326) It includes all officers and directors of private corporations rendering services for the corporation for pay unless they elect to be excluded in accordance with subsections (16), (18), or (19).[[328]](#footnote-327) A general partner of a partnership or a managing member of an LLC may similarly elect to be excluded from coverage in accordance with paragraph (17) of [subdivision (a) of section 3352](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS3352&originatingDoc=NBD1BA2E0DB3711E9A84BD3F975785B4A&refType=SP&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Document)#co_pp_8b3b0000958a4).[[329]](#footnote-328)

Excluded from the definition of “employee” are officers and directors who own at least 10% of the stock issued by the corporation or who obtain a private health insurance policy or plan and execute a waiver.[[330]](#footnote-329) Also excluded is a general partner or managing partner of an LLC, upon proof of private insurance.[[331]](#footnote-330)

Under these statutes, worker cooperatives with ten members or fewer should qualify for the exclusions so long as all members are also directors and officers of the cooperative. This may be to the worker cooperative’s benefit. While there is no express restriction in the number of LLC members that may be excluded from the workers’ compensation scheme as a managing partner of an LLC, each such LLC member must be a manager. And even if multiple LLC members do run the LLC, it probably challenges credibility if there are more than ten managing members.

| **→ PRACTICE NOTE:** An LLC worker cooperative by joint election of the board of directors and the members can come within the provisions of California’s workers’ compensation laws even when its members do not come with the statutory definition of employees.[[332]](#footnote-331) |
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It appears that workers’ compensation law is not concerned with the definition of an employee per se but rather with distinguishing an independent contractor from an employee. In this context, an independent contractor “… means any person who renders service for a specified recompense for a specified result, under the control of his principal as to the result of his work only and not as to the means by which such result is accomplished.”[[333]](#footnote-332) Any person rendering service for another, other than as an independent contractor, or unless expressly excluded herein, is presumed to be an employee.[[334]](#footnote-333) For workers for whom a license is required (e.g., contractor’s license), including workers who perform services for which a license is required, there is a rebuttable presumption that the worker is an employee instead of an independent contractor.[[335]](#footnote-334)

The California Supreme Court in Borello created a multifactor test to distinguish independent contractors from employees, which examines the overall arrangement between the parties in consideration of the purpose of the Workers’ Compensation Act.[[336]](#footnote-335) It looks at a number of factors in addition to “control” to determine whether the person providing services is actually in business for himself or herself. This sets the Borello test apart from other tests.[[337]](#footnote-336) Whether or not the parties believe they are creating an employer-employee relationship is an important factor in determining whether a worker is an employee for purposes of awarding workers’ compensation benefits.[[338]](#footnote-337) While the Borello test, which seeks to connect the purpose of the Workers’ Compensation Act with employee status, is a step in the right direction, the test still focuses only on distinguishing employees from independent contractors.

The Borello test has not been applied to worker cooperatives in any reported cases in California. The well-known Yellow Cab Cooperative v. WCAB (1991)[[339]](#footnote-338) case, in spite of its name, does not involve a worker cooperative. It was a cooperative in name only and involved a taxicab company that after bankruptcy reorganized by entering into lease agreements with former drivers/employees in which they would lease the cab for a set time and a set fee. The lessee/driver was not required to render services to the company, and either party could break the lease without notice. The company provided radio and telephone service. Because the Borello test was used to determine whether the drivers were independent contractors, it is not legal precedent for worker cooperatives where people work together in the business (as opposed to these lessees/drivers who each worked independently). But the Yellow Cab case does establish that it is the Borello test and principles (not common law) that controls the determination of employment status for workers’ compensation purposes.[[340]](#footnote-339)

While there are no reported California workers’ compensation cases where the court had to decide whether members of worker cooperatives were employees under California’s workers’ compensation law, Oregon courts have decided this issue in regard to both workers’ compensation as well as unemployment insurance (see Ekdahl v. Saif Corp., supra).

***Associated Reforestation Contractors, Inc. v. State of Oregon, Workers’ Compensation Board***

This case was brought by competitors of a worker cooperative for declaratory relief to determine whether the cooperative was subject to the workers’ compensation statute. They complained of an economic injury because the cooperative was able to underbid them because the cooperative did not pay workers’ compensation insurance premiums. The question before the court was whether the cooperative was the employer of the workers. “The court first looked at the broad language defining an employer as \* \* \* any person \* \* \* who contracts to pay a remuneration for and secures the right to direct and control the services of any person.” [ORS 656.005(14)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.005&originatingDoc=I647d8e87f39f11d983e7e9deff98dc6f&refType=SP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)#co_pp_7c720000bea05).[[341]](#footnote-340) The obligation of employers to pay workers’ compensation benefits was equally broad: “A subject employer, required by [ORS 656.017](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.017&originatingDoc=I647d8e87f39f11d983e7e9deff98dc6f&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)) to provide workers’ compensation coverage for all subject workers, is defined as an employer who employs one or more subject workers.” [ORS 656.023](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.023&originatingDoc=I647d8e87f39f11d983e7e9deff98dc6f&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)). Subject workers are defined as “all workers,” with certain exceptions to be discussed. A worker is defined as “any person \* \* \* who engages to furnish services for a remuneration, subject to the direction and control of an employer \* \* \*.” [ORS 656.005(28)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000534&cite=ORSTS656.005&originatingDoc=I647d8e87f39f11d983e7e9deff98dc6f&refType=SP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)#co_pp_da300000980a0).[[342]](#footnote-341)

In its defense, the cooperative argued that it was not an employer because (1) members are not providing services in return for remuneration; rather, members receive “a percentage” of the profits in exchange for labor; and (2) the workers are exempt because they participate in the business as partners. In refuting the first contention the court looked at the facts that showed a transitory work environment with little resemblance to a cooperative business. Membership over the years had varied from 150 to 400 members organized into crews of 12 to 30 members. Each member worked on a crew, and the crew had the power to terminate members. There was language in the bylaws about terminating a member, but the governing council could remove an entire crew without cause. And while each member had the right to one vote in the crew and to receive a share of the profits, the annual turnover rate was 25 to 30%. Also, a member could leave the co-op without notice, without cause, and without incurring liability. On these facts the court concluded, “The actualities of the relationship that member workers

bear to the cooperative belie Hoedads’ argument.”[[343]](#footnote-342)

As to the second contention, the entirety of the court’s legal analysis of the corporate structure was limited to (1) this sentence: “Even accepting the proposition that cooperatives might be distinct entities for some purpose, but not for others …” and (2) this footnote: “Cooperative associations are neither partnerships nor ordinary business corporations, and the Legislative Assembly has recognized their distinct character by enacting a special chapter of the Code to deal with them.” ORS ch 62, Kuhns v. State Tax Commission, 223 Or. 547, 554, 355 P.2d 249 (1960). Even this footnote belies the court’s conclusion because it only refers to the “distinct character” of cooperatives that requires special legislation. The court did not explain at all how working for a cooperative is the same as working for other entities. The sum total of the court’s response to the legal assertion that the cooperative should be treated like a partnership was this: “… the fact that pay is contingent on profits does not transform an employer into a partnership.”

While this may or may not be true, it completely fails to address membership equity in the cooperative, worker/membership control on a democratic basis, and the distribution of patronage dividends in worker cooperatives. In rejecting the partnership argument, the court once again pointed to the ease of membership termination, the limited control over workers, and the member’s minimal proprietary interest.

While this case is another example of bad employment case law addressing worker cooperatives, it raises the question of how the court would have ruled if the cooperative was an ongoing steady business, was democratically controlled, did not have a high turnover, had members with an actual equity interest in the co-op, maintained capitol accounts in the name of its members, made annual patronage distributions, and possibly used nonqualified patronage distributions retained by the cooperative to purchase a capitol asset like the property where the cooperative conducts its business. As case law presently stands, one can only hope for a future case based on such facts.

#### Workers’ Compensation Insurance: Conclusion

While bad facts clearly make bad law under existing workers’ compensation case law, the existing state of the law does provide some tools for the development of workers’ compensation law as applied to worker cooperatives. First it shows (by adopting the Borello test) that the definition of “employee” must relate to the purpose and reasons for the remedial legislation. And since worker cooperatives are recognized as being unique, arguably workers’ compensation laws should be uniquely applied to cooperatives. It also allows an option to be “in” or “out” of the state-controlled workers’ compensation system if and where there is true co-ownership and control in member-managed LLCs. It shows how this is to be done—by obtaining (or opting out of) insurance meeting statutory requirements.

| **Cooperative opportunity:** The option of statutory-compliant insurance, outside the workers’ compensation insurance scheme, could give rise to insurance consumer cooperatives that service the insurance needs of worker cooperatives, other types of cooperatives, as well as other business, once there is sufficient critical mass and finance to meet underwriting requirements. This in turn could give rise to more cooperatives. The Mondregon cooperatives’ use of funds collected from their own self-insurance workers’ compensation system to create a financial institution for the creation and development of new worker cooperatives and institutions serving the cooperatives should be further examined. It all started with workers’ compensation insurance. |
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### Wrongful Termination

Actionable wrongful termination exists both in contract and in tort law. In contract it is based on a contract that is either expressed or implied. Bylaws and membership agreements that express or reasonably infer a cooperative member’s right to work in the cooperative would constitute an express agreement. In that situation the legal issue is the extent there was compliance with the terms of the agreement. The breach of contract could occur not only from the failure to provide promised work but also from the failure to comply with the grounds and procedures for termination.

In addition to an action for breach of any contract expressed or implied, wrongful termination from employment is tortious when the termination occurs in violation of a fundamental public policy.[[344]](#footnote-343) A policy is “fundamental” when it is “carefully tethered” to a policy “delineated in constitutional or statutory provisions” and is “well established” and “sufficiently clear” to the employer at the time of the discharge.[[345]](#footnote-344) Wrongful termination cases typically arise when an employer retaliates against an employee for refusing to violate a statute, performing a statutory obligation, exercising a statutory right, or reporting an alleged violation of a statute of public importance.[[346]](#footnote-345) An action for tortious discharge is not strictly limited to these situations but will lie “wherever the basis of the discharge contravenes a fundamental public policy.”[[347]](#footnote-346) A tortious termination of employment subjects the employer “… to liability for compensatory and punitive damages under normal tort principles.”[[348]](#footnote-347) In order to establish a prima facie case supporting a retaliation claim, a plaintiff must show: (1) that he or she engaged in a protected activity, (2) that the employer subjected him or her to an adverse employment action, (3) a causal link between the protected activity and the employer’s action, and (4) resulting damages.[[349]](#footnote-348) A person subject to an adverse employment action including termination can also resort to several whistleblower statutes for violations of federal and state law, including complaints about invidious discriminatory conduct that led to termination and complaints about workplace safety.[[350]](#footnote-349)

The best way for worker cooperatives to avoid wrongful termination claims, whether actionable or not, is to have bylaws that specify the grounds for membership termination, or suspension of the right to work with the cooperative for a period of time. Certainly, the grounds for membership termination and the suspension of the right to work with the cooperative as stated in the bylaws should be “for cause” recognized by law. The grounds adopted by unemployment insurance for denying benefits when there is involuntary termination may provide basic standards.[[351]](#footnote-350) In addition to addressing membership termination, worker cooperatives should also have a written procedure for employment termination, or other adverse employment actions (such as demotions, shift changes, and other unfavorable changes in the terms and conditions of the worker’s employment), that provide for due process that, at a minimum, should include notice, hearing, and adjudication of the law and facts. Since good cause for terminating a worker’s membership interest is often also good cause for terminating the worker’s employment, the due process procedures should contemplate termination of both membership and employment.

| **→ PRACTICE NOTE:** Practitioners and their clients should be aware that a worker cooperative that is well run, has and follows proper bylaws, and has regular meetings where arising matters and problems can be discussed can vastly lower the risk of a claim for wrongful termination. Even so, when terminations of membership and/or employment are being considered, these decisions are often high risk, and both the worker cooperative and its attorneys should pay close attention to the bylaws and the documentation supporting the decision to terminate membership and/or employment, and ensure that the written due process steps are known, followed, and well documented. |
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#### Permitted Discrimination

Although a cooperative may deal with its members upon any reasonable basis, it may not discriminate among them unreasonably or unfairly.[[352]](#footnote-351) There is nothing to indicate that cooperatives, like other businesses, should not be subject to federal and state laws, including California’s Fair Employment and Housing Act (FEHA), prohibiting unlawful discriminatory conduct in the workplace. But under both state and federal antidiscrimination laws, not all forms of discrimination are illegal. Discrimination that is not invidious and serves a legitimate business does not violate the law. “Reasonableness … means that the distinction made can be justified in light of the purpose for which it was created.”[[353]](#footnote-352) For example, a discriminatory employment practice based upon a bona fide occupation qualification does not violate the FEHA.[[354]](#footnote-353)

This standard has been applied to cooperatives, including a worker cooperative. Paying members of a worker cooperative weighted hours was found to be reasonable based on a factual showing.[[355]](#footnote-354) Cases concerning marketing co-ops are also useful in showing what type of discrimination is reasonable. Members of a nonprofit California marketing cooperative claimed discrimination because of different payment for different grades of milk created by a corporate resolution. The court disagreed because the corporate resolution was a proper exercise of the board of directors’ authority, and it did not create a new class of members; it merely created a new procedure for the type of milk plaintiffs produced.[[356]](#footnote-355) A milk marketing cooperative did not engage in unreasonable discrimination when it discussed management policies with dues-paying members and not with non-dues-paying members.[[357]](#footnote-356) But a cooperative charging different water rates to members who received the same service was found to be discriminatory and unauthorized because the bylaws called for equal treatment among members.[[358]](#footnote-357)

| **→ PRACTICE NOTE:** The *Linnton Plywood* case, along with the other cases dealing with marketing cooperatives, may suggest a way of compensating founding members for building the equity in the cooperative in the form of goodwill and creating the platform upon which subsequent members can benefit. As noted in *Linnton,* founding members of a cooperative can be paid a premium wage so long as this form of discrimination is reasonable, not invidious, and supported by provable facts. |
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#### Wrongful Termination and Discrimination: Conclusion

As demonstrated above, the state of employment law, as it applies to worker cooperatives, is a hot mess and provides worker cooperatives with very limited guidance as to how they fit into the statutory schemes. There are no labor code statutes that pertain to worker cooperatives, and the case law that does exist borders on intellectual dishonesty because many of the cases did not involve situations where the businesses in question actually operated as a cooperative. In addition, numerous courts have failed to analyze and recognize the unique cooperative business structure in determining whether an employment relationship exists between the cooperative and its owners who are also workers. The Pugent Sound case exemplifies what these courts have routinely failed to do. Ironically, in Wynn (supra), where the employer was not exactly a worker cooperative but seemed to be guided by cooperative principles, the court engaged in a factual inquiry and found the absence of an employment relationship.

## **Cooperative Opportunity**

Given this state of affairs, individual worker cooperatives need to be aware of existing labor and employment laws and act to minimize unnecessary legal risks to their cooperative. Meanwhile, collectively, worker cooperatives need to work for meaningful comprehensive change in these laws and create the supporting institutions. To this end the following plan of action is proposed for worker cooperatives individually and collectively:

**Proposed Action Plan for Individual Worker Co-ops**

1. Conduct the business of the cooperative like a cooperative following the principles of worker ownership, democratic control, and patronage distributions, thereby factually distinguishing the worker cooperative from other kinds of corporations and partnerships, and thereby justifying legal recognition as a unique type of cooperatively owned and managed entity requiring different legal treatment.
2. Make membership control a reality in the workplace environment, including distributing executive functions among the members. In addition to showing distributed “control” for legal purposes, there are good business reasons for doing so. The liability protection of corporations, and even LLCs in some situations, can be erased if entities do not conduct themselves as the legal entity they are and/or use the legal entity as an alter ego of one or more of its members. This means the cooperative must have regular meetings where emerging matters are reviewed, decisions are made on existing matters, written records of decisions are made, members collectively assume liabilities of the entity (usually managed by insurance), business accounts are separate, and other indications of entity existence are common. Wide distribution of roles and power with a cooperative may take training and hard work, but it builds skills and internal resilience.
3. Decide whether any statutory exemptions apply to your cooperative and whether you opt in or opt out. Even if you have good reason for believing an exemption applies, file the appropriate documents, particularly those required by unemployment and workers’ compensation laws.
4. Decide whether you want to utilize alternative scheduling in determining overtime and then devise a system that complies with the wage and hour statutes and regulations.
5. Inform all workers, whether members of the cooperative or not, of their rights to take rest and meal breaks, and have them record rest and meal breaks and hours worked daily.
6. Beware of any form of invidious discriminatory conduct and take prompt remedial action.

**Proposed Action Plan for Worker Cooperatives Acting Collectively**

1. Survey worker cooperatives about working conditions, the effect of existing labor and employment laws upon them, and desired changes
2. Create and work to enact a comprehensive system of labor and employment laws that apply specifically to worker cooperatives. In particular, create a new “control” test, where the fact question is whether the workers/members have control of the employment affairs of the business, looking at the economic realities and the operational structure of the particular cooperative.
3. Create and work to enact corporate and tax law that would allow a worker cooperative LLC to convert to a corporate cooperative with relative ease.
4. Litigate cases all the way to the appellate courts if there is a strong set of facts showing the defects of existing labor and employment laws.
5. Create institutions that would serve the needs of cooperative members/workers and possibly provide them with the means of meeting certain statutory exemptions. A consumer insurance cooperative, for example, could not only meet some of these needs but also provide the funding for worker cooperative expansion.
6. Work with legislators to transform remedial employment laws into positive cooperative development, taking the U.S. Congress at its word (as expressed by its resolution in 2019). For example, if there is little or no chance under the law that worker-owners in a cooperative could collect unemployment insurance benefits, the money that those businesses and their worker-owners pay as unemployment insurance taxes could be better used to fund start-up worker cooperatives, which in turn could be part of an urban development plan. If successful, such policy changes further the objectives of labor and employment law and policies to provide a livelihood under favorable working conditions, at a living wage or better.

# Chapter 9: Dissolution Matters

*Hasmik Geghamyan*



## Introduction

Dissolution is the formal procedure for ending the life of a California corporation (or at least attempting to end). Section A of this chapter identifies the general provisions that guide cooperative dissolutions in California. Section B explains voluntary dissolution proceedings, section C explains involuntary dissolution proceedings, and section D reviews post-dissolutions considerations.

The fiduciary duties of the directors and officers continue when the cooperative elects to “wind up” and dissolve voluntarily or involuntarily through a court order or decree. The process of winding up includes any distribution of assets in contemplation of termination or abandonment of the corporate business. Directors are charged with obligations and responsibilities throughout the life of a cooperative, which may or may not end after the cooperative has been dissolved.

## General Provisions and Procedures on Cooperative Dissolutions

### Fiduciary Duties of the Directors and Officers After the Commencement of a Dissolution Proceeding

For the purposes of winding up, settling, and liquidating the affairs of a cooperative, directors and members should refer to Cal. Corp. Code section 12650 to understand the powers and duties of the directors. (The powers and duties of individuals appointed by the court in an involuntary dissolution should refer to section 12625, also explained in the section entitled [Involuntary Dissolution Proceedings](#_7g95xf16yas9) below.) It is common for a cooperative to seek legal assistance with drafting dissolution documents and filing them with the Secretary of State, if necessary. The directors will elect officers and employ attorneys and agents to help with the liquidation of winding up the cooperative’s affairs.[[359]](#footnote-358) The directors will continue to carry out the affairs of the cooperative as long as they are necessary for the disposal of assets or winding up.[[360]](#footnote-359)

**Board Vacancy and Lack of Quorum**If there is a board vacancy during the winding up of the cooperative, the vacancy may be filled by the approval of the Board unless the articles or bylaws state otherwise. If the number of directors is less than those of a quorum, then the vacancy will be filled by (1) the unanimous written consent of the directors in office, (2) the affirmative vote of a majority of the directors then in office after proper notice or waiver of notice, or (3) a sole remaining director.[[361]](#footnote-360)

**Existing Contracts, Settling Debts, and Legal Actions**

As part of their fiduciary duties to the cooperative, the directors are obligated to carry out existing contracts and collect and settle its known debts and liabilities for or against the cooperative.[[362]](#footnote-361) The directors have to be ready to defend against any suits brought against the corporation after the commencement of a dissolution proceeding, sue in the name of the corporation for any sums due or owed to the cooperative, as well as recover any of its property, collect any unpaid membership dues, or recover unlawful distributions. Unlawful distribution occurs when a claimant has a justified reason for failing to file a timely claim and the court orders the cooperative to return any distribution that belonged to the claimant.[[363]](#footnote-362)

The directors are also empowered to execute bills of sale and deeds of conveyance in the name of the cooperative, sell any part of the cooperative’s assets at a public or private sale, and exchange or convey those assets in an amount deemed reasonable by the Board without having to comply with the provisions of section 12521 relating to sales of the assets that do not involve winding up.[[364]](#footnote-363)

### When Directors Fail, Refuse to Wind Up, or Cannot Be Identified

There may be rare instances when the directors fail or refuse to wind up despite the election to wind up by members or when the directors have not been active for an extended period of time and their identity is unknown or their right to hold office is in question. When such instances occur, any interested person, including a member or claimant, may petition the superior court of the proper county to determine the identity of the directors, or if there are no directors, to appoint directors to wind up the affairs of the cooperative after hearing on such notice.[[365]](#footnote-364)

### Distribution of Assets After Debts and Liabilities Have Been Paid or Provided For

Once the Board determines that all the known debts and liabilities of the cooperative have been paid or adequately provided for,the Board is required to distribute the remaining corporate assets per Cal. Corp. Code sections 12655, 12656, and 12656.5. However, if the winding up is by a court proceeding or subject to court supervision, which is common if it is an involuntary dissolution (see section C), the Board will not distribute the remaining assets until after the expiration of any period provided to present claims by the order of the court.

### When Debts and Liabilities Are Considered “Adequately Provided For”

There may be instances when a successful payment to a creditor, member, or other individual may not be straightforward; for example, a creditor’s whereabouts cannot be ascertained after diligent inquiry or the creditor moved to another location and did not update the cooperative with a change of address. Whatever the reason may be, the Board has an obligation to ensure that the known debts and liabilities have been adequately provided for. There are two means of designating a debt or liability as “adequately provided for.”[[366]](#footnote-365)

A. A safe approach that requires more procedural and bureaucratic involvement is to deposit the amount of debt with the Controller. The Controller will then hold the funds in trust for the benefit of those lawfully entitled to the payment or the amount of the claim.[[367]](#footnote-366) This process is more common with voluntary dissolutions (see section B) but may also involve a court order requiring such deposit with the Controller in an involuntary dissolution proceeding.

B. Another approach by which a debt or liability will be considered adequately provided for is when the amount of debt has been assumed or guaranteed in good faith by one or more financially responsible individuals, or by the U.S. government or any related agency. This assumption or guarantee has to be determined in good faith and with reasonable care by the Board, including well-documented meeting notes and reasonable access to the documentation, to be adequate at the time of any distribution of the assets by the Board.[[368]](#footnote-367) This approach requires more trust that those who are financially responsible will safeguard the payment for the known debt or liability.

| **NOTE:** If the Board chooses the second method, the Board should draft a legally binding document that identifies the financially responsible entity or individual who will assume and/or personally guarantee the payment or liability. There may be instances where some security is required so that the creditor has recourse in the event the guarantor is unable to pay. |
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The remaining assets are disposed of per the manner of disposition provided in the articles or bylaws of the cooperative. If the articles or bylaws do not provide the manner of disposition, the assets will be distributed among the members according to their respective rights during the nondissolution period.[[369]](#footnote-368) Unless otherwise specified, distributions may come in different forms. They can be made either in money or in property or securities and either in installments or as a whole.

| PRACTICE NOTE: The focus of the Board is to ensure that the distributions comply with the provisions of the articles and bylaws, or if those provisions are missing, then according to the customary distribution rights that existed prior to the dissolution. If no such respective rights existed prior to the dissolution, the Board will be empowered to create them. The Board will then propose a plan of distribution for the membership to vote on. |
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In the case of a worker cooperative, the majority of the unallocated capital account will be distributed to members as specified in the articles or by laws of the cooperative. An unallocated capital account, which is also called unallocated reserves, is equity capital that has not been assigned to a specific member’s account. Typically, these distributions take the form of (1) patronage; (2) capital contributions; or (3) a combination of patronage and capital contributions. A worker cooperative is authorized to include patronage for the past and current members in its distribution of an unallocated capital account.[[370]](#footnote-369)

| **PRACTICE NOTE:** The unallocated capital account is a separate account from the indivisible reserve account, which is owned by the cooperative. Any amount that is in the indivisible reserve account will be allocated to a cooperative development organization designated in the articles or bylaws. |
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If the cooperative that is in the process of winding up has more than one outstanding class of memberships, a plan of distribution may be adopted if approved by the Board and members of each class per Cal. Corp. Code section 12224 even if the plan is not in accordance with the liquidation rights of any class or classes as specified in the articles or bylaws. The plan may state that such distribution is a complete or partial satisfaction of the rights of the members for the purpose of distribution and liquidation of assets.[[371]](#footnote-370) Once the plan of distribution is approved, it will be binding on all members. The Board is required to notify the adoption of the plan to all holders of membership having a liquidation preference within 20 days after its adoption (Cal. Corp. Code section 12658(b)).

### What Happens When Members Cannot Be Located or Refuse to Accept Their Distribution

If members cannot be located or they refuse to accept their distribution in cash or property; if the amount of the distribution is contingent, contested, or not determined; or if the ownership of any membership is in dispute, the cooperative will deposit such distribution with the Controller in trust for the benefit of those entitled to the distribution. The distribution will then be paid over by the depository to the lawful owners, or their representatives or assigns once proof of title is shown.[[372]](#footnote-371)

In California, the disposition of unclaimed property is governed by Civ. Proc. Code sections 1500 et seq. This means that unclaimed property would typically escheat to the State. California has passed a legislation to exempt cooperatives from paying over to the State abandoned patronage dividends or shares. However, in order to be exempt from escheat laws, the cooperative has to follow the requirements set forth in Cal. Corp. Code section 12446 subdivision (b).

| **NOTE:** In order to prevent unclaimed property of the cooperative from going to the State, make sure the cooperative’s articles or bylaws specifically provide for the transfer of ownership of unclaimed proprietary interest to the cooperative, and of course, follow the notice requirements in Cal. Corp. Code section 12446. |
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### Recovery of Improper Distributions and Right of Ratable Contribution

There may be instances where distributions of assets occur prior to payment of debts and liabilities or any adequate provisions in place addressing the debts and liabilities. For example, a court-ordered liability may have occurred after the distributions were already made or the cooperative inadvertently distributed its assets because the specific debt or liability was unknown at the time or there was an administrative error. If this occurs, the cooperative may request an immediate return of the improper distribution. If the person or persons who received the distribution are refusing to return the improper distribution, the Board is empowered per sections 12626(a)–(m) to bring a suit in the name of the corporation. In addition, any one or more creditors of the cooperative, whether or not they have reduced their claims to a judgment, may bring a suit in the name of the cooperative.[[373]](#footnote-372)

Any member who satisfies any liability under Cal. Corp. Code section 12660(a) has the right of ratable contribution from other distributees (likely members) who were similarly liable. If a member paid more than the member’s ratable share of the amount needed to pay the debts and liabilities of the cooperative, the member can require the Board to recover from other distributees who were similarly liable for improper distribution according to the respective rights and preferences of the memberships and after the cooperative satisfied the payment of all the debts and liabilities of the cooperative.[[374]](#footnote-373)

| **NOTE:** For example, a cooperative uncovered that it owed a cleaning company $100. The cooperative had already distributed its assets to its five members. Even though this debt was unknown at the time the distributions were made, the cooperative will have to request that each member pays $20 to pay the cleaning company or else the Board or the cleaning company could bring a legal action in the name of the cooperative against all the members to collect the $100. Once the cooperative has satisfied this debt, and if one of the members paid more than their $20 share, Member A could demand the Board to collect the additional payment from the other four members to reimburse Member A. |
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## Voluntary Dissolution Proceedings

Voluntary dissolution of a cooperative is probably the most common way of “closing shop.” The winding-up process of the cooperative may range from having a minimal number of debts and liabilities to complicated transactions such as securities, unmatured investments, and real property conveyance. The rules and procedures for voluntary dissolution of a cooperative are stated in Cal. Corp. Code sections 12630 to 12638.

### Election to Dissolve the Cooperative by Members and/or Board of Directors

A cooperative may elect to voluntarily wind up and dissolve by (1) approval of a majority of all members unless the bylaws indicate a different voting count; or (2) approval of the Board *and* approval of the members per section 12224.[[375]](#footnote-374)

There are times when the Board may solely approve voluntary dissolution. This may occur when a cooperative has no members (see Cal. Corp. Code section 12630(c)) or has been subject of an order for relief in bankruptcy. The Board may also approve to voluntarily dissolve if a cooperative has disposed of all its assets and has not conducted any activity for a period of five years immediately prior to adopting the resolution to dissolve.[[376]](#footnote-375)

Cal. Corp. Code section 12630(c) lays out circumstances when the Board may still dissolve despite having no members. The Board may elect to dissolve when there is a *unanimous* consent of the directors who are then in office or a sole remaining director casts the vote to dissolve. Another way the Board may elect to dissolve if it does not have members is through an affirmative vote of a majority of the directors then in office at a meeting that was held pursuant to waiver of notice requirements by those directors complying with section 12351(a)(3).

Once the cooperative elects to wind up and dissolve, the Board is encouraged to adopt a resolution confirming the vote.

| **NOTE:** When a corporation elects to wind up and dissolve based on subdivision (c) of section 12630 (unanimous consent by the Board, for example), any future references to the Board refer to a Board consisting of those directors or the sole director. Any subsequent action by the Board will require at least the same consent or the same majority vote. |
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### Certificate of Election to Wind Up and Dissolve

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Once a cooperative has elected to wind up and dissolve, the cooperative is required to issue a certificate to be placed in its official records evidencing that the election took place in addition to adoption of the resolution. The issuance of the certificate may depend on how the approval to wind up and dissolve occurred. The certificate may be an officers’ certificate, which means the certificate is signed and verified by then-officers of the Board, typically signed and verified by the Secretary. If there are no officers, then the certificate may be signed and verified by at least a majority of the directors then in office. In the alternative, one or more members may be permitted to sign and verify by approval of a majority of all members per section 12223.[[377]](#footnote-376)

| PRACTICE NOTE: When a document is signed and verified, such as the Certificate of Election to Wind Up and Dissolve, it means that the signatories to the document will sign under the penalty of perjury. A typical language that would go just above the signature line is: “I certify under penalty of perjury under the laws of California that the foregoing is true and correct.” |
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The certificate must contain the following information:

1. that the corporation has elected to wind up and dissolve;

2. if the election was made by the vote of members alone, the number of votes for the election and that the election was made by persons holding at least a majority of the voting power unless otherwise indicated in the bylaws;

3. if the certificate is executed by a member or members, that the subscribing person or persons were authorized to execute the certificate by persons representing at least a majority of the voting power unless otherwise indicated the bylaws; and

4. if the election was made by the Board pursuant to subdivision (b) of section 12630, the certificate shall also set forth the circumstances showing the corporation to be within one of the categories described in that subdivision

Cal. Corp. Code §12631(b)(1)-(4).

In addition to the Certificate of Dissolution, a Certificate of Election is also required to be filed with the Secretary of State unless the election to dissolve was made by a vote of all members of a cooperative per subdivision (a) of section 12630, not a majority of members, or by a vote of all directors of the Board without members per subdivision (b) of section 12630. In that case, a statement to that effect is added to the Certificate of Dissolution pursuant to section 12630 and a separate filing of the Certificate of Election is not required.[[378]](#footnote-377)

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### Revocation of Voluntary Dissolution Prior to Distribution of Any Assets

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If members of a cooperative decide to revoke the voluntary dissolution, the revocation is plausible as long as it is properly done prior to distribution of any assets. If the election to dissolve was approved by a majority of all members (section 12630(a)(1)), the Board and members (section 12630(a)(2), or the Board only (section 12630(b)), then revocation of the dissolution is allowed.[[379]](#footnote-378)

What goes in the Certificate of Revocation? It must confirm that no assets were distributed pursuant to the election to dissolve, that the corporation has revoked its election to wind up and dissolve, and how the revocation occurred. For example, if the revocation was made by the vote of members alone, the Certificate will need to list the number of votes for the revocation and that it was made by at least a majority of the voting power. If the revocation was made by the approval of the Board and approval of the members or by the Board alone, it will need to state that fact.[[380]](#footnote-379)

### Disposing Claims Against a Cooperative with Proper Written Notice

A cooperative may also dispose of (as in not pay) the known claims against it as long as notice requirements are followed. The cooperative will need to send a written notice to all known creditors and claimants per section 12633(c) containing the following information:

1. a description of any information that must be included in the claim, including the amount and services rendered;

2. a mailing address where a claim may be sent;

3. the deadline, which cannot be fewer than 120 days from the effective date of the written notice; and,

4. a statement that the claim will be barred if not received by the deadline.

If a claimant does not deliver the claim to the cooperative by the deadline or the claim was rejected by the cooperative and the claimant did not commence a proceeding to enforce the claim within 90 days from the rejection date, a claim against the cooperative will be barred.[[381]](#footnote-380)

| PRACTICE NOTE: While claims may be disposed of with proper notification and lack of challenge by the claimant within the deadline, a liability may occur sometime in the future, such as a pending lawsuit or a claim based on an event occurring after the date of dissolution. This is also known as contingent liability, which cannot be disposed of by proper notice. |
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### The Board Affairs Cannot Exceed Beyond Winding Up Unless to Preserve the Cooperative’s Goodwill or Going-Concern Value

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Once a voluntary proceeding has commenced after the vote to dissolve, and the Certificate of Dissolution has been issued (preferably both would happen close together in time), the Board will continue to act as a Board and have the full powers to wind up and settle its affairs before and after filing of the Certificate of Dissolution with the Secretary of State.[[382]](#footnote-381) Note that the cooperative will continue to operate to the extent necessary for winding up. Any unrelated activities to winding up will not be permitted unless it is to preserve the cooperative’s goodwill or going-concern value pending a sale or other disposition of its assets. The powers and duties of the Board during dissolution proceedings are described in detail in sections 12626(a)–(m).[[383]](#footnote-382)

| **NOTE:** If a cooperative has an expiration date and it is not renewed, the Board is required to terminate its activities and wind up its affairs and file a Certificate of Dissolution. |
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### Superior Court May Assume Jurisdiction in a Voluntary Dissolution Proceeding

We know that with involuntary dissolution proceedings, court intervention is inevitable. However, there will be instances where the superior court of the county where the corporation operates may assume jurisdiction over voluntary dissolution proceedings to protect the interests of the cooperative, its members, or creditors “as justice and equity may require.”

For the superior court of the proper county to assume jurisdiction over a voluntary dissolution proceeding, a petition has to be submitted by the cooperative, members possessing 5% or more voting power, or three or more creditors. Any of these categories will have to give proper notice to the cooperative and other individuals interested in the dissolution, such as creditors and members. Once the superior court of the proper county assumes jurisdiction, it may issue orders as to any and all matters concerning the winding up of the affairs of the cooperative as well as the protection of its members and creditors as justice and equity may require.[[384]](#footnote-383) The procedures and filing process for winding up may be different from the process for voluntary dissolution without the involvement of the court.

### Certificate of Dissolution

Once a corporation has been completely wound up (meaning all the known debts and liabilities have been paid for or adequately provided for and the remaining assets are distributed) *without* court proceedings, the majority of the directors then in office will sign and verify a Certificate of Dissolution.

The Certificate of Dissolution should state that:

1. the cooperative has been completely wound up;

2. its debts and liabilities have been paid or adequately provided for as far as its assets permitted or it incurred no known debts and liabilities;

3. its known assets have been distributed or that it acquired no known assets;

4. the cooperative is dissolved; and,

5. a final franchise tax return has been or will be filed with the Franchise Tax Board.[[385]](#footnote-384)

The signed and verified Certificate of Dissolution will then be filed with California’s Secretary of State. The Secretary of State will notify the Franchise Tax Board of the dissolution.

| **PRACTICE NOTE:** In California, the Secretary of State registers cooperatives under the nonprofit category even though cooperatives are not nonprofit corporations. If the dissolution was made by a vote of all the members of the cooperative or all the directors of the cooperative, instead of filing the Certificate of Dissolution, you may have an option to file Form DISS NP. |
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### An Alternative to Filing a Certificate of Dissolution: A Court-Ordered Dissolution

An alternative to filing a Certificate of Dissolution involves petitioning the superior court of the proper county for an order declaring the cooperative duly wound up and dissolved.

Why would a cooperative choose to obtain an order instead of filing the Certificate of Dissolution? It could be because the cooperative may not be able to locate all the creditors, claimants, and members to fulfill its known debts and liabilities. The judicial route will ensure that proper notice and protocols are followed, including giving notice to creditors, claimants, and members through a newspaper of general circulation once a week for three consecutive weeks. Once a petition is filed by the cooperative, the court will make an order requiring all interested persons to show cause why an order shall not be made declaring the corporation duly wound and dissolved. This order to show cause (OSC) will be served by notice to all creditors, claimants, and members in the same manner as the notice given under subdivision (b) of section 12627 in the involuntary dissolution proceedings. Once the notice procedures are fulfilled per section 12627(b), the order to show cause will expire 30 days after the last publication in a newspaper. Any person claiming to be interested as a creditor, claimant, or member may appear in the proceedings any time before the expiration of 30 days and contest the petition. If they fail to appear, that person’s claim will be barred. The court will then enter an order to dissolve the cooperative with the same provisions outlined in section 12628, and a certified copy of the order will be filed with the Secretary of State per section 12629.[[386]](#footnote-385)

## Involuntary Dissolution Proceedings

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Involuntary dissolutions are not common but can occur when there is a complaint filed with the superior court of the proper county by (1) one-half or more of the directors currently in office; (2) a person or persons holding, or authorized in writing, not less than 33 ⅓% of voting power (this may occur especially in market or ag cooperative); (3) any member if the period for which the cooperative was formed has expired without extension; or (4) any other person who is expressly authorized to do in the articles.[[387]](#footnote-386) The procedures for involuntary dissolution of a cooperative are stated in Cal. Corp. Code sections 12620 to 12629.

### Grounds for Involuntary Dissolution of a Cooperative

### 

Section 12620(b) of the Cal. Corp. Code identifies five grounds for involuntary dissolution. One ground for involuntary dissolution of a cooperative is abandonment of the cooperative for more than one year.[[388]](#footnote-387) This can happen when the cooperative is no longer active or the members have forgotten to dissolve the cooperative voluntarily. Another ground for involuntary dissolution is that the period for which the corporation was formed has expired without the extension of such period.[[389]](#footnote-388)

| **PRACTICE NOTE:** Any member of the cooperative can initiate the involuntary dissolution proceedings if the period for which the cooperative was formed has expired without an extension of such period. |
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One of the most difficult grounds for involuntary dissolution is when members are divided into factions so that they are unable to elect a board consisting of an uneven number to prevent a deadlock or the corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, or if the Board continues to proceed, there is a danger that its property will be impaired or lost, or its activities impaired.[[390]](#footnote-389)

If the ground for the complaint for involuntary dissolution of the corporation is a deadlock on the Board as set forth in paragraph (2) of subdivision (b) of section 12620, the court may appoint a provisional director.[[391]](#footnote-390) Refer to Cal. Corp. Code section 308 on the role and powers of provisional directors when there is a deadlock.

| **PRACTICE NOTE:**  There will be a time when a board struggles to make critical decisions. Aim to have an odd number of directors to prevent a deadlock. No effective action or decision can be made when there is a deadlock. Even when you list a maximum limit on the number of directors in your bylaws, make sure it is an odd number. |
| --- |

Other grounds for involuntary dissolution include the prevalence of internal conflict, such as two or more factions of members are so deadlocked that its activities can no longer be conducted with benefit to the cooperative.[[392]](#footnote-391)

| **NOTE:**  If your client is an insurance cooperative or there is a dispute with an insurance company that may prevent dissolution or disposal of a cooperative’s assets, the cooperative may not dissolve involuntarily unless consent of the Insurance Commissioner has been obtained by an application filed by the Insurance Commissioner pursuant to section 1011 of the Insurance Code.[[393]](#footnote-392) |
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Another ground for involuntary dissolution can occur as a result of the cooperative’s inability to elect successors to directors whose terms have expired or would have expired upon election of their successors. The inability to elect successors can occur during (1) any four-year period or (2) when all voting power has been exercised at two consecutive meetings or in two written ballots for the election of directors, whichever period is shorter.[[394]](#footnote-393)

A final ground of involuntary dissolution involves those who have been guilty of or knowingly approved persistent and pervasive fraud, misrepresentation, mismanagement or abuse of authority, or persistent unfairness toward any member, or the cooperative’s property is being misused, misapplied, or wasted by its directors and officers.[[395]](#footnote-394) This ground will likely involve the Attorney General’s Office (see Cal. Corp. Code section 12621(a)(2)).

| **NOTE:** If your client is an energy cooperative subject to the Public Utilities Act, the cooperative cannot dissolve or dispose of its assets unless there is an order from the Public Utilities Commission (PUC) authorizing the cooperative to dispose of its assets or dissolve.[[396]](#footnote-395) |
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### Attorney General’s Involvement on Specific Grounds

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The Attorney General’s Office is authorized to bring an action against the cooperative to procure a judgment that results in the dissolution of the cooperative, as well as annulling, vacating, or forfeiting its corporate existence on several grounds. The Attorney General’s Office’s complaint is in the name of the State of California, based on the Attorney General’s own information or from the complaint of a private party, which may or may not be named in the complaint.[[397]](#footnote-396)

The Attorney General’s Office may bring an action to dissolve the cooperative if (1) the cooperative has seriously offended any of the provisions of the statutes regulating corporations; (2) the cooperative has fraudulently abused or usurped corporate privileges or powers; (3) the cooperative has violated any provision of law by an act or default, which is a ground for forfeiture of corporate existence under the law; or (4) the cooperative failed to pay to the Franchise Tax Board (FTB) for a period of five years any tax imposed by the Bank and Corporation Tax Law.[[398]](#footnote-397)

If any of the grounds that initiated action by the Attorney General’s Office can be corrected by amendment of the cooperative’s articles or by other corporate action, such suit may not be pursued or maintained unless the Attorney General’s Office has given the cooperative a written notice of the matter at least 30 days prior to the institution of suit and the cooperative has failed to institute proceedings to correct it within the 30-day period or subsequently fails to properly make such amendment or take the corrective corporate action.[[399]](#footnote-398)

| PRACTICE NOTE: Contact the Attorney General’s Office and ask for a written extension of the 30-day period if the cooperative is unable to take corrective measures within the deadline. It is safer to get an extension than to miss this critical deadline. |
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The court may order dissolution or such other relief as it deems just and expedient. In most cases, the court will likely appoint a receiver for winding up the affairs of the cooperative unless the cooperative can be wound up by its board subject to the supervision of the court.[[400]](#footnote-399)

To comply with notice requirements, the service of process on the cooperative may be made pursuant to sections 1700 to 1702 of the Cal. Corp. Code or by written notice to the President or Secretary of the corporation at the address indicated in the cooperative’s last tax return filed. The Attorney General’s Office is also required to notify the members of the cooperative by publishing a notice of the suit in a newspaper of the county where the cooperative is located.[[401]](#footnote-400)

### 

### The Jurisdiction of the Court Once the Involuntary Proceedings for Winding Up Commences

The scope and powers of the court in an involuntary dissolution proceedings are listed in Cal. Corp. Code sections 12626(a)–(m). Some of the powers include but are not limited to requiring the proof of all types of claims, including contingent and unliquidated, against the corporation, whether due or not yet due, as well as barring creditors and claimants from participation due to failing to make and present claims and proof as required by any order. The court may also make the determination of the rights of members and of all classes of members in and to the assets of the corporation, the filing of any vacancies on the Board that the directors or the members are unable to fill, and the removal of any director if it appears that the director has been guilty of dishonesty, misconduct, neglect, or breach of trust in conducting the winding up or the director is unable to act. For a full list of scope and powers of the court’s jurisdiction, read section 12626 (a)–(m).

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### Appointment of a Receiver Pending the Hearing and Determination of the Complaint for Dissolution

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If the court has reasonable grounds to believe that the interests of the cooperative or its members will suffer pending the hearing and determination of the complaint for dissolution, the court may appoint a receiver to take over and manage the affairs of the cooperative and to preserve its property. Pursuant to sections 566 and 567 of the Code of Civil Procedure, a receiver may be appointed upon an ex parte application of the plaintiff and after a hearing of such notice to the cooperative as the court may direct and upon the giving of security to make sure the cooperative complies.[[402]](#footnote-401)

| **NOTE:**  An appointed receiver cannot be a party, or attorney of a party, or person interested in an action or related to any judge of the court by kinship or affinity within third degree without filing the written consent of the parties with the clerk of the court. |
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### Winding Up and Dissolution of the Cooperative by Court Order

After the hearing on the complaint for dissolution, the court may order a winding up and dissolution of the cooperative if a cause is shown per section 12620. Alternatively, if justice and equity require, the court may make orders and decrees as well as issue injunctions with or without an order for winding up and dissolution.[[403]](#footnote-402) Once the order for winding up is entered per section 12624, the involuntary proceedings for winding up and dissolving a cooperative begins.[[404]](#footnote-403)

The Board is generally the responsible body involved in the winding up of the affairs of the cooperative, subject to the supervision of the court. However, if good cause has been shown per section 12623, a receiver may be appointed by the court to conduct the winding up of the affairs of the cooperative.[[405]](#footnote-404) Once the involuntary dissolution proceedings have commenced, the cooperative is required to cease corporate activities unless they are necessary for winding up or to preserve the cooperative’s goodwill or going-concern value, pending a sale or other disposition of its assets.

Unless the order for winding up has been stayed by appeal, or the proceeding or the execution of the order has been enjoined, the directors or such other appointed individuals are required to send a written notice of the commencement of the proceedings to all members and all known creditors and claimants whose addresses are on the records of the cooperative.[[406]](#footnote-405) The written notice on involuntary winding up must generally be sent by mail unless the order allows the Board or such other appointed individuals to follow the notice requirements listed in the bylaws.

### Filing Deadlines for Creditors and Claimants to Participate in Distribution of the Assets

The directors or the court-appointed individual(s) are required to send a publication of notice to creditors. The notice must be published not less than once a week for three consecutive weeks in a newspaper of general circulation published in the county in which the proceeding is pending, or if there is no such newspaper published in that county, in such newspaper as may be designated by the court. The notice must direct creditors and claims to make present claims and proofs within the time specified in the notice. A copy of the notice must be mailed to each person shown as a creditor or claimant on the books of the cooperative, at the person’s last known address.[[407]](#footnote-406)

All creditors and claimants may be barred from participation in any distribution of the general assets of the cooperative if they fail to make and present claims and proofs of claims within the time period directed by the court. The general timeline is between four to six months after the first publication of notice to creditors. If an affidavit confirms that there are no claims, the time limit may be shortened to three months. If a claimant can show that they did not receive a notice because they were absent from the state or for some other reason that the court finds justified, the court may allow a claim to be filed or presented at any time before distribution is completed.[[408]](#footnote-407)

| PRACTICE NOTE: Directors or court-appointed individual(s) are required to mail two types of notices to members, creditors, and claimants whose addresses are on the records of the cooperative per section 12625(c) once a court order or decree is entered to wind up the cooperative: (1) They must send a written notice of the commencement of the proceedings for involuntary winding up before the notice has been published in a general circulation for three consecutive weeks. (2) When the notice has been published in a general circulation for three consecutive weeks per instructions from the court order or minutes, the directors or court-appointed individual(s) will mail the second notice to each person known as creditors or claims on the books of the cooperative. |
| --- |

Prior to any distributions from the cooperative’s assets, when there are unmatured, contingent, or disputed claims against the cooperative and the court has allowed those claims to be presented or views the holder entitled to the claim if the claim were due, the cooperative will pay those amounts to the court. The amount will then be paid over to the party when the party becomes entitled to those funds. However, if the party fails to establish a claim based on unmatured, contingent, or disputed grounds, those funds will be paid over or distributed with the other assets of the cooperative to those who are entitled to them. The court also has the jurisdiction to make provisions for the full payment of claims if and when the court deems it adequate. Holders of secured claims may be required to prove the entire debt.[[409]](#footnote-408) A creditor whose claim was allowed but was not yet due will be entitled to its present value upon distribution of assets.[[410]](#footnote-409)

If a member, creditor, or claimant has a potential suit against the cooperative because the claim was rejected, the claimant has 30 days after receiving a written notice of rejection to file a suit on the rejected claim. Otherwise, their claim will be barred.[[411]](#footnote-410)

### Court Order Declaring the Corporation as Duly Wound and Dissolved

Once the court determines that the cooperative’s affairs are in a condition for it to be dissolved, including final settlement of the accounts of the directors or other appointed individuals such as a receiver if such compensation was required or approved, the court may make an order declaring that the cooperative is duly wound up and dissolved.[[412]](#footnote-411)

The order will be made after the corporation has been duly wound up, a final franchise tax return has been filed with the Franchise Tax Board as required under part 10.2 (commencing with section 18401 of division 2 of the Revenue and Taxation Code), and the corporation’s known debts and liabilities have been paid as far as its assets permitted or adequately provided for. The order should also state that its known assets have been distributed or that it acquired no known assets, the accounts of directors or such appointed individuals were settled, and they are discharged from their duties and liabilities to creditors and members.[[413]](#footnote-412)

If the order contains assumption or guaranty of the debts and liabilities as part of “adequately provided for” satisfaction of the debts and liabilities, it must contain how the agreement or provision was made, with the name and address of the corporation, person, or governmental agency that has assumed or guaranteed the payment, or the name of the depositary with which a deposit has been made, as well as any other information to enable the creditor or other claimants to appear and claim payment of debt or liability.

The court may make additional orders and grant further relief if it deems proper based on the evidence presented.[[414]](#footnote-413) Once the order declares that the corporation is dissolved, the corporate existence stops and directors or such appointed individuals are discharged from their duties and liabilities except to further winding up if necessary, such as recovering distributions after a dissolution or becoming a party to a quiet title action.[[415]](#footnote-414) A certified copy of the order must be kept with corporate records and filed with the Secretary of State. The Secretary of State will then notify the Franchise Tax Board of the dissolution.[[416]](#footnote-415)

| **NOTE:** It is recommended for the directors or such appointed individuals who filed the final order with the Secretary of State to follow up with the Franchise Tax Board to make sure that it has been notified of the cooperative’s dissolution. |
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## Post-Dissolution Considerations

### Cooperative’s Activities and Involvement After Dissolution

A cooperative that is declared as dissolved through a court order or filing with the Secretary of State) may nevertheless continue to exist for the narrow purpose of winding up its affairs. Even if the status of the cooperative is dissolved, the cooperative will be able to prosecute and defend actions, collect and discharge obligations, dispose of and convey its property, and divide assets as necessary. The cooperative may not continue its activities unrelated to dissolution. If the cooperative is part of a legal action or proceeding, the dissolution of the cooperative will not stop such legal action or proceeding. If there are assets that were inadvertently left out from accounting, the dissolved cooperative will continue to wind up for the purpose of fulfilling its obligations to the members and claimants.[[417]](#footnote-416)

### Lawsuits Against a Dissolved Cooperative

Lawsuits against a dissolved cooperative for actions occurring before or after the dissolution of the cooperative may be enforced against the dissolved corporation’s undistributed assets, including insurance assets held by the corporation, or “against other persons to the extent of their pro rata share of the claim or to the extent of the corporate assets distributed to other persons, whichever is less.”[[418]](#footnote-417)

To be able to file a suit against a person who possibly received an improper distribution after the cooperative has been dissolved, the claimant will have to start a legal proceeding to enforce the cause of action against that person prior to either (1) the expiration of the statute of limitations applicable to the cause of action or (2) four years after the effective date of the dissolution of the corporation.[[419]](#footnote-418) This means that if a claimant found out that a member received an improper distribution that belonged to the claimant after the dissolution, their cause of action may be extinguished unless it comes within the statute of limitation or four years after the effective date of dissolution of the cooperative, whichever one is earlier.

Proper service of the summons or other legal process against a dissolved cooperative can be effectuated by delivering a copy of the complaint to an officer, director, or person in charge of the cooperative’s assets; if that person cannot be located, then it should be delivered to the agent for service of process. If the claimant or complainant is still unable to locate someone, then they will have to show an affidavit to the satisfaction of the court that due diligence was exercised to locate a person in charge of the cooperative’s assets. At that point, the court may make an order that the summons or other legal process be served on the dissolved corporation by personally delivering a copy of the complaint along with the court’s order to the Secretary of State or an Assistant or Deputy Secretary of State.[[420]](#footnote-419)

### The Dissolved Cooperative Exists Indefinitely When Sued in a Quiet Title Action

One action that is not subject to the limitations of section 12662 is a quiet title action. An action to quiet title is a lawsuit brought in a court over property disputes. The dissolved cooperative survives and continues to exist indefinitely for the purpose of being sued in a quiet title action. Any judgment that is rendered in a quiet title action will bind each and all of the members of the cooperative and other individuals to the extent of their equity or interest in the quiet title action.

As we can surmise, the life of a cooperative does not cease to exist but takes on a different shape after it has been dissolved.

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# Author Biographies

*Alex Glancy*

Alex is an attorney at [Gundzik Gundzik Heeger LLP](https://www.gghllp.com/), where she practices transactional law for startups, social enterprises, impact-oriented companies, and individuals. She advises both new founders and established companies on corporate structure and governance, investment fundraising, and contracts of all types. Alex is experienced with the formation of business entities including LLCs, corporations, benefit corporations, non-profits, and cooperative corporations. As companies bring on investors, she counsels on fundraising strategies and handles securities compliance at the federal and state levels. Alex also practices intellectual property law for entrepreneurs and creatives. She drafts and negotiates license agreements, NDAs, and work-for-hire agreements. She has represented graphic designers, visual artists, and producers in these areas.

Alex graduated from Harvard Law School, where she participated in the Community Enterprise Project. She holds a bachelor’s degree with honors from Northwestern University in Mathematical Methods in the Social Sciences (MMSS) and Anthropology. Prior to joining GGH LLP, she worked at the Arts Law Centre of Australia, the Office of the General Counsel of New York University, and at a global law firm.

Born and raised in Los Angeles, Alex prides herself on being a community lawyer of service to her city and wider community. She is passionate about legal innovations to promote community wealth-building and sustainability. She has presented to groups at UCLA, California Institute of the Arts, Collective REMAKE, and Suffolk University School of Law.

*Allison Curtis*

Allison is a Senior Social Enterprise Consultant with [The ICA Group](https://icagroup.org/about/) and co-directs the organization's business conversion program. Allison works with business owners across ICA’s industries and geographies who are pursuing transitions to employee ownership. This involves guiding business owners through the exit planning process, conducting financial and operational analysis on the feasibility of an employee ownership transition, and supporting owners and workers through the entire transition process. Allison is passionate about cooperative ownership as a tool to increase worker power and create access to well-paying jobs. She is located in Western Massachusetts.

*Brett Heeger*

Brett is a founding partner of [Gundzik Gundzik Heeger LLP](https://www.gghllp.com/), where his practice focuses on transactional corporate and securities matters with a passion for social enterprise and economic democracy. He supports a wide range of client companies, leveraging legal tools to support all of their goals: from profit and growth, to impact and inclusion.

Brett has substantial experience leading clients through the process of planning for and bringing investment into their companies. From designing and managing friends and family rounds, direct public offerings (DPOs), navigating Regulation A+ and public company compliance, to negotiating venture investments and exit opportunities, Brett prides himself on his ability to work with clients to find the right investment tools and opportunities to position their business for success. Brett also leads the firm's social enterprise and worker-owned cooperative efforts in Southern California. He has represented multiple cooperatives and members, and regularly presents and advises on legal matters for new and existing co-ops and social-impact minded businesses in Los Angeles.

Brett is a Legal Fellow of the Sustainable Economies Law Center, and a member of the California Center for Cooperative Development and National Coalition for Community Capital. His work was recently recognized as a finalist for the 2021 Grunin Prize by NYU Law School’s Grunin Center for Law and Entrepreneurship for its contribution to the impact investing space. Brett received his J.D. from Harvard Law School, cum laude.

*Hasmik Geghamyan*

Hasmik Geghamyan is a community lawyer and educator. She believes that a cross-functional model of activism, policy, organizing, and law can be effectively used to bring about transformative post-capitalist social and economic change. Hasmik’s law practice focuses on democratic transitions of land into various models of community ownership, general labor law compliance and services for cooperatives, small businesses, and nonprofits. Her law office's active vision is to be part of a long-term, thriving community rooted in resilience and empowerment.

Hasmik has been organizing with the [National Lawyers Guild](https://www.nlg.org/) (NLG) since law school and currently sits on the Board of the National Lawyers Guild, Bay Area Chapter as well as on the Board of the [Sustainable Economies Law Center](http://theselc.org/). Hasmik can be reached at [geghamyanlaw@gmail.com](mailto:geghamyanlaw@gmail.com).

*Jennie Msall*

Jennie is a consultant for employee owned businesses. Her most recent prior work was with the ICA Group, where she led the Group’s business conversions work, assisting dozens of companies with their transitions to worker cooperatives. In this role she worked on owner exit planning, business valuation, financial and operational feasibility, governance design, and completing transactions. Jennie also supported ICA Group’s team of cross-program consultants working on cooperative conversions across the Group’s target industries and geographies, and aimed to create a community of practice focused on continual learning and process improvement. As a consultant, she’s committed to creating and delivering client service strategies and tools to scale the employee ownership field.

*Jonathan Ward*

Jonathan is the Director of Lending for [The Fund for Jobs Worth Owning](https://icagroup.org/jobsworthowning/), a 501c3 nonprofit loan fund created by The ICA Group. The Fund for Jobs Worth Owning provides flexible, non-extractive financing for cooperatives, and for innovative projects like shared service networks to scale the employee ownership sector. From 2014 through 2019, Jonathan led the employee ownership conversions program at ICA, assisting dozens of companies with their ownership transitions. His work on conversions includes exit planning and business valuation, governance design and worker training. Today, Jonathan manages lending and outreach work for The Fund, connecting with borrowers and helping to organize the capital for employee ownership conversions and strategic initiatives to grow coops.

*Kelsey Jae*

Kelsey is an attorney licensed in Idaho and Oregon who supports social entrepreneurs and people committed to cooperation and collaborative culture. This includes business transactions and guidance, amicable divorce, modest estate planning, cannabis compliance, and almost anything that will help her clients sustain meaningful livelihoods in a more resilient economy. Her *pro bono* work currently focuses on child protection cases with the CASA program. She frequently authors publications and gives presentations about issues relating to her broad yet niche practice, which can be summarized as "helping awesome people do awesome things."

Her years of service in groups such as FARE Idaho, Idaho Organization of Resource Councils, Idaho Chapter of the U.S. Green Building Council, Idaho Energy Collaborative, Idaho Strategic Energy Alliance, Sustainable Community Connections of Idaho, and Idaho Green Fest sharpened her expertise in Idaho’s energy and environmental issues while building relationships with diverse leaders in various fields. Kelsey began her legal career at a large law firm with a focus on environmental and land use law. In 2016, she became a Fellow with the Sustainable Economies Law Center and launched her solo practice, [Law for Conscious Leadership](http://www.kelseyjaenunez.com/).

Kelsey has a JD/Master of Public Policy from Pepperdine University and a BS in Biology from the University of Idaho. In addition to lawyering, she co-owns [The Vervain Collective,](http://www.thevervaincollective.com/) a plant-based apothecary with a natural health care consultation space and classroom in Garden City, Idaho. Kelsey characterizes herself as a "high performing lady of leisure" who works a lot while also being firmly committed to joy, relaxation, dancing, taking road trips to music festivals, and pondering the meaning of life.

*Kim Arnone*

Kim is Managing Partner at [Cutting Edge Counsel](https://www.cuttingedgecounsel.com/) and [Cutting Edge Capital](https://www.cuttingedgecapital.com/). She specializes in developing community capital raising strategies for social enterprises, cooperatives and nonprofits. She works primarily on investment offerings that can be publicly offered and that are open broadly to community members such as Regulation Crowdfunding, Regulation A, exempt offerings and direct public offerings. Kim has assisted a wide range of enterprises in successfully raising capital; from a worker-owned green waste recycling company to a global technology nonprofit, from a rural community development fund to an urban food coop; and many more. Kim has been with Cutting Edge for 9 years and has been practicing law for 25 years. She earned her Juris Doctorate from Hastings College of Law, where she was editor-in-chief of the Women’s Law Journal. Kim lives, works, and plays in Oakland.

*Neil Aaron Helfman*

Neil lives and practices law in Richmond, California. He graduated from the University of California at Berkeley in 1968 with a Bachelor of Arts Degree in History, and from the University of San Francisco School of Law in 1985. Since 1987 he has been a practicing attorney in the State of California, in both state and federal courts, and has appeared before administrative, trial, and appellate courts. His primary practice has been construction law, labor law, and business torts. He has also formed, advised, and represented worker cooperatives. In addition to legal services, he has written a number of published legal articles for Am Jur’s Proof of Facts (3rd series) about independent contractors, piercing the corporate veil, and unfair business practices, among other subjects, that have been cited in both state and federal court reported cases. He also wrote Choosing A Workers’ Cooperative- Another Way of Doing Business in California, 5 CEB Business Law Practitioner 28 (Winter 1990) and The Application Of Labor Law To Worker Cooperatives. University of California at Davis, Center For Cooperatives (1992). Prior to being an attorney he was a member of three AFL-CIO unions and the Teamsters, and worked as a carpenter on commercial construction projects, a farm labor, a drill rig operator in a copper mine, and an in-the-stands beer vendor during San Francisco 49ers games when Joe Montana was quarterback. He continues to be involved in the building trades and design, and seeks to form a cooperative Bauhaus that will be based on the building trades as well other industrial arts. If you are interested and have something to contribute to this venture please contact him at [neilhelfman@gmail.com](mailto:neilhelfman@gmail.com).

*Sam Gray*

Sam is an attorney(J.D., Cardozo School of Law 2013; New York Bar) based in New York City, where he represents small businesses and worker cooperatives. He loves working with mission oriented companies, creative types, and businesses that are interested in operating more democratically. Much of his work involves providing legal support to existing businesses that are converting into worker cooperatives, and he regularly works alongside the ICA Group as a legal advisor to their cooperative clients. His clients have ranged from natural builders, yogis, therapists, programmers, coworking companies, graphic designers, and educators seeking to operate on a cooperative basis. Outside of his private practice, he has worked with Brooklyn Legal Services Corporation A’s Community Economic Development program, supporting community health centers, nonprofits, affordable housing developments, and a budding community land trust in New York City. He has been a fellow with the Sustainable Economies Law Center since 2015, and he is committed to supporting people and organizations that are building resilient local economies. Outside of work, Sam enjoys writing, music, spending time with family and friends, and being outdoors as much as possible.

*Sarah Kaplan*

Sarahis an attorney licensed in California and Illinois, focusing on legal structuring, transactions, and capital-raising for cooperatives and other mission-driven enterprises. Sarah started a law practice serving cooperatives in 2012, and in 2021 she joined [Cutting Edge Counsel](https://www.cuttingedgecounsel.com), a California-based firm that plays a leading role in helping mission-driven enterprises to access non-traditional forms of capital-raising. Sarah has served a wide range of cooperatives, including worker, consumer, agricultural, cannabis, platform, investment, and multi-stakeholder co-ops. Sarah regularly guides clients through the design and compliance aspects of capital-raising, including fund formation.

Sarah has been part of the Fellows program of the Sustainable Economies Law Center since 2013. Sarah graduated magna cum laude from Chicago-Kent College of Law in 2010, and has an A.B. in Ecology from Princeton University. Sarah has previously lived in Chicago and the East Bay Area of California, and now lives in St. Louis, Missouri. You can reach Sarah at [sarah@cuttingedgecounsel.com](mailto:sarah@cuttingedgecounsel.com).

*Van Baldwin*

Van has worked professionally with consumer and worker cooperatives, other organizations, and individuals for several decades. He received his B.B.A. from Baylor University (majoring in accounting), attended graduate school at U.C. Berkeley (including serving as an accounting teaching assistant), and received his law degree from U.C. Hastings. Van is a member of the California State Bar Association and is a Certified Public Accountant in California. He has taught business law classes at Golden Gate University and San Francisco State University and has served several times on the Nonprofit Organizations Committee, formerly of the State Bar of California and now the California Lawyers Association. Van has authored several cooperative-related publications, including the Legal Sourcebook for California Cooperatives: Start-up and Administration (2004). He has also been a speaker at numerous co-op conferences over the years. He has assisted with the formation of various California cooperatives and has provided on-going accounting and legal services to co-ops. Van has recently authored proposed legislation to expand the California securities exemption for co-ops formed under the state’s Cooperative Corporation Law.

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1. These seven core principles are elaborated upon in numerous resources, including the International Cooperative Alliance’s web page on Cooperative Identity, Values and Principles: <https://www.ica.coop/en/cooperatives/cooperative-identity>. [↑](#footnote-ref-0)
2. *Id.* [↑](#footnote-ref-1)
3. Yet! At the time of publication, the Cooperative Professionals Guild had taken the lead on analyzing the potential of a uniform law that could be presented to state legislatures for adoption. To follow along with this conversation, *see* <https://www.professionals.coop/>. [↑](#footnote-ref-2)
4. To assist with research in various jurisdictions, SELC has produced a state-by-state resource guide that continues to grow. *See* <https://www.co-oplaw.org/>. When considering options, note that organizations can operate cooperatively and form as Limited Liability Companies (LLCs), Nonprofit Mutual Benefit Corporations, or any entity that can include cooperative principles and practices in their governance. [↑](#footnote-ref-3)
5. This language comes from Idaho’s statute, Idaho Code § 22-2601. [↑](#footnote-ref-4)
6. Note that Community Land Trusts (“CLTS”) are often conflated with housing cooperatives. CLTs may meet some of the same goals as housing cooperatives, and may even have housing cooperatives as part of their real estate holdings/portfolio, but they are distinct legal entities featuring community based models of stakeholder governed or managed land and housing. [↑](#footnote-ref-5)
7. With drafting and research support provided by D Abuyounes and Weixin Yang. [↑](#footnote-ref-6)
8. Bus. & Prof. Code § 6068(e); Cal. Rules of Prof. Cond. 1.6(b); Cal. Rules of Prof. Cond. 1.18. [↑](#footnote-ref-7)
9. *Think Outside the Boss: How to Create a Worker-Owned Business*, a manual produced by the Sustainable Economies Law Center and others, is available at https://www.theselc.org/legal-guides. [↑](#footnote-ref-8)
10. Cal. Rules of Prof. Cond. 1.16(a)(2),(3). [↑](#footnote-ref-9)
11. Cal. Rules of Prof. Cond. 1.1. [↑](#footnote-ref-10)
12. Cal. Rules of Prof. Cond. 1.1(b). [↑](#footnote-ref-11)
13. Cal. Rules of Prof. Cond. 1.1(a), see In re Brockway, 06 Cal. Daily Op. Serv. 4014 (Cal. Bar Ct., May 15, 2006). [↑](#footnote-ref-12)
14. Lucas v. Hamm, 56 Cal.2d 583, 591 (1961). [↑](#footnote-ref-13)
15. Cal. Rules of Prof. Cond. 1.13; Responsible Citizens v. Superior Court, 16 Cal. App. 4th 1717 (1993). [↑](#footnote-ref-14)
16. Cal. Rules of Prof. Cond. 1.13. [↑](#footnote-ref-15)
17. See, e.g., Blevin v. Mayfield, 189 Cal. App. 2d 649, 652 (1961); Lessing v. Gibbons, 6 Cal. App. 2d 598, 606 (1935). [↑](#footnote-ref-16)
18. Cal. Rules of Prof. Cond. 1.7(d). [↑](#footnote-ref-17)
19. Bus. & Prof. Code § 6068[e]. [↑](#footnote-ref-18)
20. Bus. & Prof. Code § 6068(m); Cal. Rules of Prof. Cond. 1.4. [↑](#footnote-ref-19)
21. For model language of informed written consent in the context of multiple representation, see *Practicing Law in the Sharing Economy*, by Janelle Orsi. [↑](#footnote-ref-20)
22. See Sheppard, Mullin, Richter & Hampton, LLP v. J-Mfg. Co. Inc., 6 C5th 59 (2018). [↑](#footnote-ref-21)
23. Cal. Rules of Prof. Cond. 1.7[c][2]. [↑](#footnote-ref-22)
24. *Id.*  [↑](#footnote-ref-23)
25. Cal. Rules of Prof. Cond. 1.8.1; see ABA Model Rules of Prof. Cond. 1.8, 1.13. [↑](#footnote-ref-24)
26. Cal. Rules of Prof. Cond. 1.4. [↑](#footnote-ref-25)
27. Cal. Rules of Prof. Cond. 1.4(b). [↑](#footnote-ref-26)
28. Libarian v. State Bar of California, 21 Cal.2d 862, 865 (1943). [↑](#footnote-ref-27)
29. *Id.* [↑](#footnote-ref-28)
30. *Id.* [↑](#footnote-ref-29)
31. Bus. & Prof. Cond. § 6148(c). [↑](#footnote-ref-30)
32. *Id.* [↑](#footnote-ref-31)
33. Cal. Rules of Prof. Cond. 1.9(c) [↑](#footnote-ref-32)
34. Corp. Code § 12201. [↑](#footnote-ref-33)
35. Corp. Code § 12201.5(b); *see also* Corp. Code § 12244, defining “patronage distribution” as “any transfer made to a patron of the corporation the amount of which is computed with reference to the patron’s patronage of the corporation.” [↑](#footnote-ref-34)
36. *See* Corp. Code § 12238(a). [↑](#footnote-ref-35)
37. [Col. Rev. Stat., tit. 7, art. 58, part 514](https://advance.lexis.com/api/document/collection/statutes-legislation/id/61P5-X0W1-DYDC-J1TN-00008-00?cite=C.R.S.%207-58-514&context=1000516). [↑](#footnote-ref-36)
38. [Corp. Code § 12300(a)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12300.). [↑](#footnote-ref-37)
39. [*See* Corp. Code § 12313](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12313.). [↑](#footnote-ref-38)
40. Corp. Code § 12300(b). [↑](#footnote-ref-39)
41. “The number or minimum number of directors shall not be less than three.” [Corp. Code. § 12331(a)](https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CORP&sectionNum=12331.). [↑](#footnote-ref-40)
42. Corp. Code § 17704.07(r)(1). [↑](#footnote-ref-41)
43. The author acknowledges accountant Teree Castania for making this clear to the cooperative practitioner community. [↑](#footnote-ref-42)
44. Corp. Code §§ 100-2319. [↑](#footnote-ref-43)
45. Corp. Code § 204(a)(3). [↑](#footnote-ref-44)
46. Corp. Code § 14610(c). [↑](#footnote-ref-45)
47. *See* Corp. Code § 14620. [↑](#footnote-ref-46)
48. *See* Corp. Code § 14630. [↑](#footnote-ref-47)
49. *See* Corp. Code §§. 14601(b), 14623. [↑](#footnote-ref-48)
50. *See* Corp. Code § 12256. [↑](#footnote-ref-49)
51. *See* Corp. Code § 12403. [↑](#footnote-ref-50)
52. Corp. Code § 12314. [↑](#footnote-ref-51)
53. *See* Corp. Code § 12420(c). [↑](#footnote-ref-52)
54. Democracy at Work Institute and the U.S. Federation of Worker Cooperatives, *2019 Worker Cooperative State of the Sector Report* (2019). [↑](#footnote-ref-53)
55. Cal. Corp. Code § 12200. [↑](#footnote-ref-54)
56. State-By-State Co-op Law: California, <https://www.co-oplaw.org/knowledge-base/california/#Model_Articles_of_Incorporation_Bylawsfor_Worker_Cooperatives_under_California8217s_new_law>. [↑](#footnote-ref-55)
57. *See* Van P. Baldwin, *Legal Sourcebook for California Cooperatives: Start-up and Administration* (2004) at 15, http://www.cccd.coop/sites/default/files/resources/LegalSourcebookForCaliforniaCooperatives\_0.pdf. [↑](#footnote-ref-56)
58. Cal. Corp. Code § 12460.5, https://leginfo.legislature.ca.gov/faces/billCompareClient.xhtml?bill\_id=201520160AB816&showamends=false. [↑](#footnote-ref-57)
59. Sustainable Economies Law Center Organizational Policies, https://docs.google.com/document/d/1UTuTZ\_R8tpzdRuGXX7-bey7W25ZgvFnPZCyGgGwiGSg/edit. [↑](#footnote-ref-58)
60. The ICA Group is a leading expert on worker ownership and the oldest national organization dedicated to the development of worker cooperatives. Since 1977, ICA has launched dozens of worker-owned cooperatives and social enterprises, helped dozens of companies convert to worker ownership, and created and preserved over 10,000 jobs. [↑](#footnote-ref-59)
61. Cal. Corp. Code § 12350. [↑](#footnote-ref-60)
62. Baldwin, *supra* note 4 at 15. [↑](#footnote-ref-61)
63. Cal. Corp. Code § 12570. [↑](#footnote-ref-62)
64. Cal. Corp. Code § 12353. [↑](#footnote-ref-63)
65. Cal. Corp. Code § 12570. [↑](#footnote-ref-64)
66. Baldwin, *supra* note 4 at 87-88. [↑](#footnote-ref-65)
67. Baldwin, *supra* note 4 at 88-89. [↑](#footnote-ref-66)
68. Baldwin, *supra* note 4 at 89. [↑](#footnote-ref-67)
69. Cal. Corp. Code §§ 12580-12583, §§ 12590-12594, and §§ 12600-12608. [↑](#footnote-ref-68)
70. Cal. Corp. Code § 12590. [↑](#footnote-ref-69)
71. Cal. Corp. Code § 12591. [↑](#footnote-ref-70)
72. Cal. Corp. Code § 12591(b). [↑](#footnote-ref-71)
73. Cal. Corp. Code § 12591(c). [↑](#footnote-ref-72)
74. Cal. Corp. Code § 12594. [↑](#footnote-ref-73)
75. Cal. Corp. Code § 12580. [↑](#footnote-ref-74)
76. Cal. Corp. Code § 12583. [↑](#footnote-ref-75)
77. Cal. Corp. Code § 12600. [↑](#footnote-ref-76)
78. Cal. Corp. Code § 12601. [↑](#footnote-ref-77)
79. Cal. Corp. Code § 12603. [↑](#footnote-ref-78)
80. Cal. Corp. Code § 12604. [↑](#footnote-ref-79)
81. Cal. Corp. Code § 12608. [↑](#footnote-ref-80)
82. 26 U.S. Code § 11,<https://www.law.cornell.edu/uscode/text/26/11>. [↑](#footnote-ref-81)
83. 26 U.S. Code § 1361-1379, <https://www.law.cornell.edu/uscode/text/26/subtitle-A/chapter-1/Subchapter-S>. [↑](#footnote-ref-82)
84. 26 U.S. Code § 1381-1388,<https://www.law.cornell.edu/uscode/text/26/subtitle-A/chapter-1/subchapter-T>. [↑](#footnote-ref-83)
85. Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue, 44 T.C. 305 (1965). [↑](#footnote-ref-84)
86. Internal Revenue Services, PLR \_\_\_ (September 11, 2017**)** responding to U.S. Rep. Jared Polis, <https://drive.google.com/file/d/1GAGwZboVGjcvSq2ye6xH_YeeXIAVMZxQ/view?usp=sharing> [↑](#footnote-ref-85)
87. Ben Craig and John Pencavel, *The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest*, The American Economic Review, Vol. 82, No. 5 (Dec., 1992), pp. 1083-1105, <https://www.jstor.org/stable/2117468?origin=JSTOR-pdf&seq=1.> [↑](#footnote-ref-86)
88. Subchapter T uses the word “Patronage Sourced Income,” which is then often shortened to “Patronage Income.” 26 CFR § 1.1388-1. [↑](#footnote-ref-87)
89. In a 1976 tax case ([Linnton Plywood Ass’n v. United States, 410 F.Supp. 1100 (D.C. Ore. 1976)](https://www.co-oplaw.org/knowledge-base/caselaw/#Linnton_Plywood_Assn_v_United_States_410_FSupp_1100_DC_Ore_1976)), a federal District Court in Oregon allowed a worker cooperative to add weight to the number of hours worked by Members in the calculation of patronage income. The effect was to increase patronage and the base of patronage-sourced income available for deductible patronage dividends. Such weighting reflected the cooperative’s assessment of the value added to the company by Members. The court endorsed a formula that valued Member hours at 150% of non-Member hours, provided the cooperative was able to demonstrate the value added by Members as contrasted with the value added by non-Members. Much of this proof centered on the responsibilities Members assumed for management (including sitting on the Board of Directors and staffing committees of the board). In addition, expert testimony was presented on the relative value of work performed by owners and non-owners. Other worker cooperatives can advance similar arguments, provided that the Members play a significant role in the governance of the cooperative and that the cooperative can demonstrate the increased productivity of employee-owners as compared to non-owners. The primary effect of a weighted formula would be to increase the percentage of a cooperative’s revenues eligible for distribution as deductible Patronage Dividends. [↑](#footnote-ref-88)
90. 26 U.S. Code § 1361-1379. [↑](#footnote-ref-89)
91. Internal Revenue Manual, Part 20.1.3: Estimated Tax Penalties (July 23, 2020), <https://www.irs.gov/irm/part20/irm_20-001-003r>. [↑](#footnote-ref-90)
92. Internal Revenue Services, PLR-123691-18 (November 16, 2019), <https://www.irs.gov/pub/irs-wd/201918013.pdf>. [↑](#footnote-ref-91)
93. Internal Revenue Service, Limited LIability Companies (March 16, 2021), https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc. [↑](#footnote-ref-92)
94. Internal Revenue Manual, Part 20.1.3: Estimated Tax Penalties (July 23, 2020), <https://www.irs.gov/irm/part20/irm_20-001-003r>. [↑](#footnote-ref-93)
95. Bader Martin CPAs, Tax Considerations for New Partners: What You Need to Know (December 2016), <https://badermartin.com/tax-considerations-for-new-partners-what-you-need-to-know/>. [↑](#footnote-ref-94)
96. Farrel Fritz, Partnership Tax Allocations: Follow the Economics (February 3, 2016),

    <https://www.taxlawforchb.com/2016/02/partnership-tax-allocations-follow-the-economics/>. [↑](#footnote-ref-95)
97. 26 U.S.C. §§ 1381-1388. [↑](#footnote-ref-96)
98. 26 U.S.C. § 1381. [↑](#footnote-ref-97)
99. Corp. Code §§ 12200-12704. [↑](#footnote-ref-98)
100. *See* Corp. Code § 12451 limiting “distributions” to 15% multiplied by contributions to capital; Corp. Code § 12235 (“‘Distribution’ means the distribution of any gains, profits or dividends to any member as such, but does not include patronage distributions.” This definition means that “distributions” include a dividend on stock). [↑](#footnote-ref-99)
101. Federal law provides a definition of “reside” or “resident” in Rule 147 and in Rule 147A, 17 C.F.R. §§ 230.147 and 230.147A. [↑](#footnote-ref-100)
102. 15 U.S.C. §§ 77a-77aa [↑](#footnote-ref-101)
103. The SEC website, sec.gov, contains many pages leading to published orders, letter rulings, staff interpretations, and other guidance. One place to start is https://www.sec.gov/regulation/staff-interpretations. [↑](#footnote-ref-102)
104. 15 U.S.C. § 77b(a)(1) (emphasis added). [↑](#footnote-ref-103)
105. SEC v. WJ Howey Co., 328 U.S. 293, 298-99 (1946), available at https://scholar.google.com/scholar\_case?case=12975052269830471754&q=howey+&hl=en&as\_sdt=4,60. [↑](#footnote-ref-104)
106. Deutsch Energy Co. v. Mazur, 813 F. 2d 1567 (9th Cir. 1987) (internal citation omitted). [↑](#footnote-ref-105)
107. Forman, 421 U.S. 837, 851 (1975). [↑](#footnote-ref-106)
108. 55 Cal. 2d 811, 361 P. 2d 906 (1961), available at https://scocal.stanford.edu/opinion/silver-hills-country-club-v-sobieski-29868. [↑](#footnote-ref-107)
109. Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 814, 361 P. 2d 906 (1961). [↑](#footnote-ref-108)
110. *Id*. at 815. [↑](#footnote-ref-109)
111. *Id*. [↑](#footnote-ref-110)
112. *Id*. [↑](#footnote-ref-111)
113. 15 U.S.C. §§ 77a-77aa. [↑](#footnote-ref-112)
114. Corp. Code §§ 25000-25707. [↑](#footnote-ref-113)
115. C.C.R. § 260.000-260.617. [↑](#footnote-ref-114)
116. Corp. Code § 12451. [↑](#footnote-ref-115)
117. *See* Corp. Code § 12404 (“Except as permitted in Sections 12314 and 12404.5, the voting power of members having voting rights shall be equal.”). Section 12314 is not relevant to worker cooperatives. Section 12404.5(a) provides, “The worker-members of a worker cooperative shall have voting power as provided in subdivision (a) of Section 12253.” Section 12253(a) provides, “‘Voting power’ means the power to vote for the election of directors at the time any determination of voting power is made and does not include the right to vote upon the happening of some condition or event that has not yet occurred.” The part of section 12404.5 that permits unequal voting rights is subdivision (c), which defines the voting rights of community investor members. Taken together, these provisions require that all worker-members of a worker cooperative have equal voting rights. [↑](#footnote-ref-116)
118. *See* Howey, *supra*. [↑](#footnote-ref-117)
119. *See* section 3(a)(11) of the Securities Act of 1933, 15 U.S.C. s. 77c(a)(11); *see also* Rule 147, 17 C.F.R. 230.147, and Rule 147A, 17 C.F.R. 230.147A. [↑](#footnote-ref-118)
120. Corp. Code § 25019. [↑](#footnote-ref-119)
121. *See, e.g.,* pp. 17-35 of this agreement: https://www.co-oplaw.org/knowledge-base/cartoon-operating-agreement-coop-llc/. [↑](#footnote-ref-120)
122. Corp. Code § 25102(f). [↑](#footnote-ref-121)
123. 26 I.R.C. §§ 1381-1388. [↑](#footnote-ref-122)
124. The generally accepted international statement of the cooperative principles can be found here: https://www.ica.coop/en/cooperatives/cooperative-identity. [↑](#footnote-ref-123)
125. 26 U.S.C. §§ 1381-1388. [↑](#footnote-ref-124)
126. 26 U.S.C. § 1381. [↑](#footnote-ref-125)
127. *See* Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965). [↑](#footnote-ref-126)
128. *Id*. [↑](#footnote-ref-127)
129. *Id*. at 308. [↑](#footnote-ref-128)
130. *Id*. [↑](#footnote-ref-129)
131. *Id*. at 310. [↑](#footnote-ref-130)
132. 7 U.S.C. § 291. (This law is from 1922!) [↑](#footnote-ref-131)
133. Corp. Code §§ 12200-12704. [↑](#footnote-ref-132)
134. *See* Corp. Code § 12451 limiting “distributions” to 15% multiplied by contributions to capital; Corp. Code § 12235 (“‘Distribution’ means the distribution of any gains, profits or dividends to any member as such, but does not include patronage distributions.” This definition means that “distributions” include a dividend on stock). [↑](#footnote-ref-133)
135. I.R.S. Priv. Ltr. Rul. Release No. 0946057” (Nov. 13, 2009), available at <https://www.irs.gov/pub/irs-wd/0946057.pdf> (“The contributors of capital to the organization do not control or receive *most* of the pecuniary benefits of the organization’s operations (i.e. subordination of capital)” (emphasis added). [↑](#footnote-ref-134)
136. *See* Corp. Code § 12420: “(a) Except as provided in subdivision (b) [relating to rights of worker-members], a corporation may issue memberships having different rights, privileges, preferences, restrictions, or conditions, as provided in its articles or bylaws. If the articles or bylaws authorize at least one class of voting memberships, a corporation may also authorize and issue additional classes of memberships, preferred or otherwise, that are divisible into a series or are nonvoting or both. [↑](#footnote-ref-135)
137. In this context, a “promoter” is a person who sells stock or subscriptions (agreements to buy) stock before or after the corporation is formed. [↑](#footnote-ref-136)
138. Corp. Code § 12553(a). [↑](#footnote-ref-137)
139. Corp. Code § 12238(f). [↑](#footnote-ref-138)
140. See Rule 147 or Rule 147A, 17 C.F.R. §§ 230.147 or 230.147A, for safe harbors under federal securities law for offerings in one state. [↑](#footnote-ref-139)
141. This was necessary because at the time, section 25100(r) did not allow issuance of stock to members that would add up to more than $1,000 in aggregate, even if the cooperative wanted to issue patronage dividends in the form of stock. At the time of this writing, Assembly Bill 283 (Chen, 2021) has been passed by the California Assembly and Senate and awaits the Governor’s signature. If enacted, it will fix this problem, allowing cooperatives to issue patronage dividends in the form of stock, even if that stock adds up to more than $1,000. [↑](#footnote-ref-140)
142. Ming-Hsiang Kao v. Joy Holiday, 12 Cal. App. 5th 947, 956; 219 Cal. Rptr. 3d 580 (2017). [↑](#footnote-ref-141)
143. Builders Commonwealth, Inc. v. Dep’t of Employment and Economic Development, Minn. App. 814 N.W.2d 49, 56 (2012). [↑](#footnote-ref-142)
144. *Id*. [↑](#footnote-ref-143)
145. Kuhns v. Horn, 223 Or. 547, 554; 355 P.2d 249 (1960). [↑](#footnote-ref-144)
146. Denton Electric Cooperative, Inc. v. Hackett, 368 S.W.2d 765, 777, citing [Miss. Chem., 405 U.S. 298, 308 n. 14; 92 S.Ct. at](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1972127084&pubNum=0000708&originatingDoc=Idc2b096c9a9811e1b66bbd5332e2d275&refType=RP&fi=co_pp_sp_708_914&originationContext=document&transitionType=DocumentItem&contextData=(sc.DocLink)#co_pp_sp_708_914) 9[14 n. 14](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1972127084&pubNum=0000708&originatingDoc=Idc2b096c9a9811e1b66bbd5332e2d275&refType=RP&fi=co_pp_sp_708_914&originationContext=document&transitionType=DocumentItem&contextData=(sc.DocLink)#co_pp_sp_708_914) (2012). [↑](#footnote-ref-145)
147. *Id*. at 778. [↑](#footnote-ref-146)
148. Puget Sound Plywood v. Commissioner of Internal Revenue, 44 T.C. 305, 309 (1965), cited by Hon. M Carr Ferguson, Assist. Atty. Gen., Tax Division, Dep’t of Justice (CC-RE-570-76). [↑](#footnote-ref-147)
149. 116th Congress, H.R. Res. 602, Sept. 26, 2019. [↑](#footnote-ref-148)
150. 18 Am. Jur. 2d, Cooperative Associations § 7. [↑](#footnote-ref-149)
151. See Illinois Grain Corp. v. Commissioner*,* 87 T.C. 435, 449 (1986). [↑](#footnote-ref-150)
152. 7 U.S.C. §§ 291, 292. [↑](#footnote-ref-151)
153. See B. Rosenberg & Sons v. St. James Sugar Co-op, 447 F. Supp 1, 4 (E.D. La. 1976). [↑](#footnote-ref-152)
154. Linton v. Desoto Cab Co., 15 Cal. App. 5th 1208, 1215; 223 Cal. Rptr. 3d 761 (2013). [↑](#footnote-ref-153)
155. *Id.* [↑](#footnote-ref-154)
156. Borello & Sons v. Dep’t of Industrial Relations, 48 Cal. 3d 341, 351; 256 Cal. Rptr. 543 (1989). [↑](#footnote-ref-155)
157. People v. Superior Court (Sahlolbei), 3 Cal. 5th 230, 235; 219 Cal. Rptr. 3d 436 (2017). [↑](#footnote-ref-156)
158. Borello & Sons v. Dep’t of Industrial Relations, *supra*, 48 Cal. Rptr. 3d at 356-359. [↑](#footnote-ref-157)
159. See 22 CCR § 4304-1. [↑](#footnote-ref-158)
160. National Mutual Insurance Co. v. Darden, 503 U.S. 318, 321; 112 S.Ct. 1344 (1992). [↑](#footnote-ref-159)
161. Revenue Ruling 87-41, 1987-1 C. B. 296, 298-299. [↑](#footnote-ref-160)
162. Goldberg v. Whitaker House Coop, Inc., 366 U.S. 28, 33; 91 S.Ct. 933 (1961). [↑](#footnote-ref-161)
163. Guerrero v. Superior Court, 213 Cal. App. 4th 912, 928; 153 Cal. Rptr. 3d 315 (2013). [↑](#footnote-ref-162)
164. 29 U.S.C. § 203(g). [↑](#footnote-ref-163)
165. Zheng v. Liberty Apparel Co., 355 F.3d 61, 67 (2d Cir. 2003). [↑](#footnote-ref-164)
166. Discussed in the Corporation section. [↑](#footnote-ref-165)
167. Dynamex Operations West, Inc. v. Superior Court of Los Angeles, 4 Cal. 5th 903; 232 Cal. Rptr. 3d (2018). [↑](#footnote-ref-166)
168. Cal. Labor Code § 2750.5; Cal Unemployment Ins. Code § 631. [↑](#footnote-ref-167)
169. Dynamex Operations West, Inc. v. Superior Court of Los Angeles, *supra*, 4 Cal. 5th at 950, fn. 20 (2018). [↑](#footnote-ref-168)
170. *Id.*at 958, fn. 26. [↑](#footnote-ref-169)
171. Rest., Employment § 1.01, subds. (a), (b); see also FedEx Home Delivery v. NLRB*,* 563 F.3d 492, 497 (D.C. Cir. 2009). [↑](#footnote-ref-170)
172. Okoro v. Pyramid 4 Egis, WL1410025 (E.D. Wisconsin 2012). [↑](#footnote-ref-171)
173. Linton v. Desoto Cab Co., *supra*, 15 Cal. App. 5th at 1216. [↑](#footnote-ref-172)
174. Gutierrez v. Brand Energy Services of California, Inc., 50 Cal. App. 5th 786, 796; 264 Cal. Rptr. 3d 173 (2020). [↑](#footnote-ref-173)
175. Borello & Sons v. Dep’t of Industrial Relations*, supra,* 48 Cal. 3d at353-354. [↑](#footnote-ref-174)
176. *Id.* at 356-359. [↑](#footnote-ref-175)
177. Messenger Courier Association of the Americas v. California Unemployment Insurance Appeals Board, 175 Cal. App. 4th 1074; 96 Cal. Rptr. 3d 797 (2009). [↑](#footnote-ref-176)
178. *Id.* [↑](#footnote-ref-177)
179. [Lab. Code §§ 50](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS50&originatingDoc=I1e9a07c0c2aa11e8b1cdeab7e1f6f07a&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)), 50.5; Six Flags, Inc. v. W.C.A.B.,145 Cal. App. 4th 91; 51 Cal. Rptr. 3d 377 (2006). [↑](#footnote-ref-178)
180. Lab. Code § 1173. [↑](#footnote-ref-179)
181. [Lab. Code § 50.6](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS50.6&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)), referring to [29 U.S.C.A. §§ 201](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000546&cite=29USCAS201&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category))-[219](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000546&cite=29USCAS219&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)). [↑](#footnote-ref-180)
182. [Lab. Code §§](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS50.6&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)) 56, 70. [↑](#footnote-ref-181)
183. [Lab. Code §§](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS50.6&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)) 29-33; Faulkinbury v. Boyd & Associates, Inc., 216 Cal. App. 4th 220; 156 Cal. Rptr. 3d 632 (2013). [↑](#footnote-ref-182)
184. See Kilby v. CVS Pharmacy, Inc*.*, 63 Cal. 4th 1, 13; 201 Cal. Rptr. 3d 1 (2016). [↑](#footnote-ref-183)
185. [Lab. Code § 98](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS98&originatingDoc=I1e9a07c0c2aa11e8b1cdeab7e1f6f07a&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)). [↑](#footnote-ref-184)
186. Lab. Code § 90.5, subd. (b). [↑](#footnote-ref-185)
187. [Lab. Code §§](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000215&cite=CALBS50.6&originatingDoc=I2ae89bc0a11611d9ad0a81db1eb1d417&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)) 70, 70.1. [↑](#footnote-ref-186)
188. Lab. Code §§ 1173, 1178.5. [↑](#footnote-ref-187)
189. Lab. Code § 1177; Murphy v. Kenneth Cole Productions, Inc.,  40 Cal. 4th 1094, 1102, footnote 4; 56 Cal. Rptr. 3d 880 (2007). [↑](#footnote-ref-188)
190. Liday v. Sim, 40 Cal. App. 5th 359, 369; 253 Cal. Rptr. 3d 179 (2019). [↑](#footnote-ref-189)
191. Naranjo v. Spectrum Security Services, Inc.*,* 40 Cal. App. 5th 444, 463; 253 Cal. Rptr. 3d 248 (2019). [↑](#footnote-ref-190)
192. Brinker Restaurant Corp. v. Superior Court, 53 Cal. 4th1004, 1027; 139 Cal. Rptr. 3d 351 (2012). [↑](#footnote-ref-191)
193. [Gerard v. Orange Coast Memorial Medical Center,](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=2047056591&pubNum=0007052&originatingDoc=Ide872780ea3011e9be36860eb2f983f8&refType=RP&fi=co_pp_sp_7052_448&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)#co_pp_sp_7052_448)6 Cal. 5th 443, 448; 240 Cal. Rptr. 3d 757 (2018). [↑](#footnote-ref-192)
194. Gomez v. Lincare, Inc., 173 Cal. App. 4th 508, 513; 93 Cal. Rptr. 3d 388 (2009). [↑](#footnote-ref-193)
195. Martinez v. Combs, 49 Cal. 4th 35, 62; 109 Cal. Rptr. 3d 514 (2010). [↑](#footnote-ref-194)
196. *Id.* at 64. [↑](#footnote-ref-195)
197. *Id.* [↑](#footnote-ref-196)
198. IWC Work Order 2-4001. [↑](#footnote-ref-197)
199. Faulkinbury v. Boyd & Associates, Inc., 216 Cal. App. 4th 220, 237; 156 Cal. Rptr. 3d 632 (2013). [↑](#footnote-ref-198)
200. Lab. Code §1193.5. [↑](#footnote-ref-199)
201. Lab. Code § 217. [↑](#footnote-ref-200)
202. Lab. Code § 1193.6(a). [↑](#footnote-ref-201)
203. Lab. Code § 21. [↑](#footnote-ref-202)
204. Augustus v. ABM Security Services, Inc., 2 Cal. 5th 257, 263; 211 Cal. Rptr. 3d 634 (2016) as modified on denial of reh’g (Mar. 15, 2017). [↑](#footnote-ref-203)
205. Kilby v. CVS Pharmacy, Inc., *supra*, 63 Cal. 4th 9. [↑](#footnote-ref-204)
206. Gov. Code § 12920; [Horsford v. Board of Trustees of California State Univ.](http://www.westlaw.com/Link/Document/FullText?findType=Y&serNum=2007218723&pubNum=0007047&originatingDoc=I2ae8e9e9a11611d9ad0a81db1eb1d417&refType=RP&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)), 132 Cal. App. 4th 359, 373; 33 Cal. Rptr. 3d 644 (2005). [↑](#footnote-ref-205)
207. Gov. Code § 12993, subd. (a); as to civil rights generally, see [Cal. Jur. 3d, Civil Rights §§ 1](http://www.westlaw.com/Link/Document/FullText?findType=Y&serNum=0284110947&pubNum=0122377&originatingDoc=I2ae8e9e9a11611d9ad0a81db1eb1d417&refType=TS&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category))-[121](http://www.westlaw.com/Link/Document/FullText?findType=Y&serNum=0443424538&pubNum=0122377&originatingDoc=I2ae8e9e9a11611d9ad0a81db1eb1d417&refType=TS&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)). [↑](#footnote-ref-206)
208. Gov. Code § 12964.5, subds. (a), (b). [↑](#footnote-ref-207)
209. Lab. Code § 432.6 (effective Jan. 1, 2020). [↑](#footnote-ref-208)
210. Gov. Code § 12940, subd. (a). [↑](#footnote-ref-209)
211. Gov. Code § 12940, subd. (a). [↑](#footnote-ref-210)
212. Gov. Code § 12940, subd. (b). [↑](#footnote-ref-211)
213. Gov. Code § 12940, subd. (c). [↑](#footnote-ref-212)
214. Rosenfeld v. Abraham Joshua Heschel Day School, Inc.*,* 226 Cal. App. 4th 886, 898; 172 Cal. Rptr. 3d 465 (2014). [↑](#footnote-ref-213)
215. Rall v. Tribune 365, LLC, 43 Cal. App. 5th 638; 256 Cal. Rptr. 3d 775, 779 (2019) (de-published April 1, 2020). [↑](#footnote-ref-214)
216. Gov. Code § 12940, subd. (k)(2). [↑](#footnote-ref-215)
217. Gov. Code § 12940, subd. (k)(3). [↑](#footnote-ref-216)
218. Gov. Code § 12940; Shepard v. Loyola Marymount Univ., 102 Cal. App. 4th 837, 842; 125 Cal. Rptr. 2d 829 (2002). [↑](#footnote-ref-217)
219. 2 Cal. Code Regs. § 11008(c). [↑](#footnote-ref-218)
220. Farias v. Amtrak*,* no. SA CV 15–0633 DOC (AJWx), 2015 WL 4749002 at \*3?4 (C.D. Cal. Aug. 11, 2015). [↑](#footnote-ref-219)
221. Husman v. Toyota Motor Credit Corp*.*, 12 Cal. App. 5th 1168, 1181; 220 Cal. Rptr. 3d 42 (2017). [↑](#footnote-ref-220)
222. Sandell v. Taylor-Listug, Inc., 188 Cal. App. 4th 297, 314; 115 Cal. Rptr. 3d 453 (2010). [↑](#footnote-ref-221)
223. Hersant v. Department of Social Services, 57 Cal. App. 4th 997, 1005; 67 Cal. Rptr. 2d 483 (1997). [↑](#footnote-ref-222)
224. Corp. Code § 16202. [↑](#footnote-ref-223)
225. Chambers v. Kay, 29 Cal. 4th 142, 150-151; 126 Cal. Rptr. 2d 536 (2002). [↑](#footnote-ref-224)
226. Corp. Code § 16202, subd. (c)(3)(A) to (F). [↑](#footnote-ref-225)
227. Duryea v. Burt, 28 Cal. 569 (1865). [↑](#footnote-ref-226)
228. Corp. Code § 16306, subd. (a). [↑](#footnote-ref-227)
229. Corp. Code § 17703.04(a); Ontiveros v. Constable, 27 Cal. App. 5th 259, 273; 237 Cal. Rptr. 3d 892 (2018). [↑](#footnote-ref-228)
230. Corp. Code § 17701.02(o). [↑](#footnote-ref-229)
231. Corp. Code § 17703.01(d). [↑](#footnote-ref-230)
232. 26 C.F.R. § 301.7701-3. [↑](#footnote-ref-231)
233. Cal. Rev. & Tax. Code § 23038. [↑](#footnote-ref-232)
234. Feiger v. Winchell, 205 Cal. App. 2d 123, 129; 22 Cal. Rptr. 901 (1962); see also In re Yam 381 B.R. 747 (N.D. Cal 2007) (applying California law). [↑](#footnote-ref-233)
235. See 15A Cal. Jur. 3d Corporations §§ 1085-1088. [↑](#footnote-ref-234)
236. 29 C.F.R. § 2510.3–3(c)(2). [↑](#footnote-ref-235)
237. Wheeler v. Hurdman, 825 F.2d 257, 268 (10th Cir. 1987); see also Agee v. Grunert, 349 F. Supp. 2d 838, 846 (D. Vt. 2004) (finding partners who participate in managing the organization, generally not employees under the ADA). [↑](#footnote-ref-236)
238. Marshall v. R & M Erectors, Inc., 429 F. Supp 771, 781 (D. Del. 1977). [↑](#footnote-ref-237)
239. Sievert v. Simmons, 89 Cal. App. 2d 34, 38 (1948). [↑](#footnote-ref-238)
240. Unemployment Insurance Code § 623. [↑](#footnote-ref-239)
241. Exclusion must be in accordance with paragraph (17) of subdivision (a) of section 3352. See Labor Code § 3351(f) (effective Jan. 1, 2020). [↑](#footnote-ref-240)
242. Wheeler v. Hurdman, *supra*, 825 F.2d 257 at 271. [↑](#footnote-ref-241)
243. *Id*. at 274. [↑](#footnote-ref-242)
244. *Id*. at 271-272. [↑](#footnote-ref-243)
245. *Id.* at 273-274. [↑](#footnote-ref-244)
246. Wirtz v. Construction Survey Cooperative, 235 F. Supp. 621, 622 (D. Conn. 1964). [↑](#footnote-ref-245)
247. *Id.* at 624. [↑](#footnote-ref-246)
248. Goldberg v. Whitaker House Cooperative, Inc., 366 U.S. 28, 32-33; 81 S.Ct. 933 (1961). [↑](#footnote-ref-247)
249. United States Department, Wage and Hour Division Opinion Letter, Jan. 21, 1997, 1997 WL 957908 (DOL WAGE-HOUR). [↑](#footnote-ref-248)
250. Clackamas Gastroenterology Assocs., P.C. v. Wells*,* 538 U.S. 440, 450; 81 S.Ct. 933 (2003). [↑](#footnote-ref-249)
251. *Id.* at 446. [↑](#footnote-ref-250)
252. *Id.* [↑](#footnote-ref-251)
253. Feldman v. Hunterdon Radiological Associates, 187 N.J. 229, 242; 902 A. 2d 544 (2006). [↑](#footnote-ref-252)
254. Bluestein v. Central Wisconsin Anesthesiology, 769 F.3d 944, 953 (10th Cir. 2014). [↑](#footnote-ref-253)
255. Smith v. Castaways Family Diner, 2005 WL 1431894, \*4, 2005 U.S. Dist. Lexis 37822, \*11–12 (N.D. Ind.), and the same decision for co-owners of a business; Walls v. Avpro, Inc., 2005 WL 855931, \*2, 2005 U.S. Dist. Lexis 6375, \*6–7 (D. Md.). [↑](#footnote-ref-254)
256. Liday v. Sim, 40 Cal. App. 5th 359, 369; 253 Cal. Rptr. 3d 179 (2019). [↑](#footnote-ref-255)
257. Linton v. Desoto Cab, Inc., 15 Cal. App. 5th *supra* at 1220. [↑](#footnote-ref-256)
258. In re United Parcel Wage and Hour Cases, 190 Cal. App. 4th 1001, 1010; 118 Cal. Rptr. 3d 834 (2011). [↑](#footnote-ref-257)
259. Goldthrope v. Cathay Pacific Airways Ltd., 279 F. Supp. 3d 1001, 1005 (N.D. Cal. 2018). [↑](#footnote-ref-258)
260. Gonzales v. San Gabriel Transit, Inc., 40 Cal. App. 5th 1131, 1159; 253 Cal. Rptr. 3d 681 (2019) (review granted). [↑](#footnote-ref-259)
261. *Id.* at 1160. [↑](#footnote-ref-260)
262. Linton v. Desoto Cab, Inc., 15 Cal. App. 5th *supra* at 1220; see also Cotter v. Lyft, Inc., 60 F. Supp. 3d 1067 (N.D. Cal. 2015). [↑](#footnote-ref-261)
263. See also [8 Cal. Code Reg. §§ 11010](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000937&cite=8CAADCS11010&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category))-[11150](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000937&cite=8CAADCS11150&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)). [↑](#footnote-ref-262)
264. Reynolds v. Bement, 36 Cal. 4th 1075, 1085-1086; 43 Cal. Rptr. 3d 483 (2005). [↑](#footnote-ref-263)
265. CA DIR’s Exemptions from Overtime Laws: https://www.dir.ca.gov/dlse/faq\_overtimeexemptions.htm. [↑](#footnote-ref-264)
266. Barbosa v. Impco Technologies, Inc., 179 Cal. App. 4th 1116, 1122; 101 Cal. Rptr. 3d 923 (2009). [↑](#footnote-ref-265)
267. Early v. Sup. Ct., 79 Cal. App. 4th 1420, 1433; 95 Cal. Rptr. 2d 57 (2000). [↑](#footnote-ref-266)
268. Lab. Code § 510, subd. (a); see also [8 Cal. Code Reg. § 11010, subd. (3)(A)](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000937&cite=8CAADCS11010&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)). [↑](#footnote-ref-267)
269. See 8 Cal. Code Reg. §§ 11010-[11150](http://www.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000937&cite=8CAADCS11150&originatingDoc=I4113d2aeb67411d9947c9ea867b7826a&refType=LQ&originationContext=document&vr=3.0&rs=cblt1.0&transitionType=DocumentItem&contextData=(sc.Category)). [↑](#footnote-ref-268)
270. Morillion v. Royal Packing Co., 22 Cal. 4th 575, 582; 94 Cal. Rptr. 2d 3 (2000) as modified (May 10, 2000) (construing Cal. Code Reg. tit. 8 § 11140, subd. (2)(G), which defines “hours worked” as the time during which an employee is subject to the control of an employer and includes all the time the employee is suffered or permitted to work, whether or not required to do so). [↑](#footnote-ref-269)
271. Lab. Code § 510, subd. (a); see also 8 Cal. Code Reg., § 11010, subd. (3)(A) & (B). [↑](#footnote-ref-270)
272. IWC Wage Order 4-2001; 8 Cal. Code Regs. § 11040(11) & (12). [↑](#footnote-ref-271)
273. Murphy v. Kenneth Cole Prods., Inc., 40 Cal. 4th 1094, 1114; 56 Cal. Rptr. 3d 880 (2007). [↑](#footnote-ref-272)
274. Brinker Restaurant Corp. v. Superior Court, 53 Cal. 4th, supra at 1040–1041. [↑](#footnote-ref-273)
275. Driscoll v. Granite Rock Co., 10 Cal. Rptr. 3d 819, 826 (2016). [↑](#footnote-ref-274)
276. Brinkley v. Public Storage, Inc., 84 Cal. Rptr. 3d 873, 883 (2012); Hernandez v. Chipotle Mexican Grill*,* 118 Cal. Rptr. 3d 110, 118 (2012). [↑](#footnote-ref-275)
277. Cicairos v. Summit Logistics, Inc., 133 Cal. App. 4th 949, 963; 35 Cal. Rptr. 3d 243 (2005). [↑](#footnote-ref-276)
278. Kirby v. Immoos Fire Protection, Inc., 53 Cal. 4th 1244, 1252-1253; 140 Cal. Rptr. 3d 173 (2012). [↑](#footnote-ref-277)
279. 8 Cal. Code Regs. § 11050, subd. (7); for employment record-keeping obligations, see 41 Cal. Jur. 3d Lab. Code § 99. (Q: Is this correct?) [↑](#footnote-ref-278)
280. The author represented a worker cooperative against the claims of two members that they did not receive breaks even though they were directors and officers of the cooperative, and duty officers at the time claimed they did not take breaks. The co-op did not have any written records of breaks or witnesses to dispute the claims and thus had to settle. [↑](#footnote-ref-279)
281. Hernandez v. Mendoza*,* 199 Cal. App. 3d 721, 727; 245 Cal. Rptr. 36 (1988). [↑](#footnote-ref-280)
282. See Borham v. Lieberman, Cal. App. Unpub. LEXIS 3505 \* 7 (2014) (California Court of Appeal, First Appellate District 2014) citing Hernandez, *supra*, 199 Cal. App. 3d at 727. [↑](#footnote-ref-281)
283. Hernandez v. Mendoza, *supra*, 199 Cal. App. 3d at 727. [↑](#footnote-ref-282)
284. Lab. Code § 217, 218. [↑](#footnote-ref-283)
285. Lab. Code § 1193.6(a). [↑](#footnote-ref-284)
286. Gentry v. Superior Court, 53 Cal. 4th 443, 562-563; 137 Cal. Rptr. 3d 1 (2008). [↑](#footnote-ref-285)
287. Sonic-Calabasas, Inc. v. Moreno, 174 Cal. App. 4th 546, 548-549; 94 Cal. Rptr. 544 (2009). [↑](#footnote-ref-286)
288. Godoy v. Restaurant Opportunity Center of New York, Inc., 615 F. Supp. 2d 186 (S.D.N.Y. 2009). [↑](#footnote-ref-287)
289. *Id*. at 194-195. [↑](#footnote-ref-288)
290. [Shumaker v. Commissioner](https://login.proxylib.csueastbay.edu/login?qurl=https://1.next.westlaw.com%2fLink%2fDocument%2fFullText%3ffindType%3dY%26serNum%3d1979000528%26pubNum%3d0001051%26originatingDoc%3dI72bc170b2e8c11dbbffafa490ee528f6%26refType%3dRP%26originationContext%3ddocument%26transitionType%3dDocumentItem%26contextData%3d%28sc.Search%29), T.C. Memo, 1979-71, *aff’d in part and rev’d in part*, [648 F.2d 1198 (9th Cir. 1981)](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1981124160&pubNum=0000350&originatingDoc=I72bc170b2e8c11dbbffafa490ee528f6&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)). [↑](#footnote-ref-289)
291. Central Illinois Public Service Co. v. United States, 435 U.S. 21, 31; 98 S.Ct. 917 (1978). [↑](#footnote-ref-290)
292. CC-RL-570-76, memo from Stuart E. Seigal to Hon. M. Carr Ferguson, Assistant Attorney General Tax Division, Dep’t of Justice, Dec. 16, 1977. [↑](#footnote-ref-291)
293. Memo from Michael A. Thrasher, Assistant Chief, Branch 5, Interpretative Division, to Director of Refund Litigation development, March 6, 1978. [↑](#footnote-ref-292)
294. IRS FSA Field Service Advisory, Jan. 13, 1994, 1994, WL 1725382 (IRS FSA). [↑](#footnote-ref-293)
295. Proposed Rules Department of the Treasury, Internal Revenue Service 26 CFR Part 1, 84 FR 28668-01, 2019 WL 2514605(F.R.). [↑](#footnote-ref-294)
296. Saif v. Ekdahl, 170 Or. App. 193., 12 P.3d 57 (2000). [↑](#footnote-ref-295)
297. *Supra* at 198. [↑](#footnote-ref-296)
298. Affiliated Foods, Inc. v. Commissioner of Internal Revenue, 128 T.C. 62, 89 (2007). [↑](#footnote-ref-297)
299. CUIC § 100; Skidel v. C.U.I.A.B., 24 Cal. App. 5th 574, 581; 234 Cal. Rptr. 3d 528 (2018). [↑](#footnote-ref-298)
300. *Id.* [↑](#footnote-ref-299)
301. Empire State Mines Co. v. California Employment Commission, 28 Cal. 2d 33, 43 (1946). [↑](#footnote-ref-300)
302. Skidel v. C.U.I.A.B., *supra*, 24 Cal. App. 5th at 581. [↑](#footnote-ref-301)
303. 22 CCR § 4304-1. [↑](#footnote-ref-302)
304. Messenger Courier Association of the Americas v. C.U.I.A.B., 175 Cal. App. 4th 1074, 1094-1095; 96 Cal. Rptr. 3d 797 (2009). [↑](#footnote-ref-303)
305. CUIC § 656. [↑](#footnote-ref-304)
306. CUIC §§ 629-637, 649-655. [↑](#footnote-ref-305)
307. CUIC § 622. [↑](#footnote-ref-306)
308. CUIC § 621, subd. (c)(2). [↑](#footnote-ref-307)
309. CUIC § 623. [↑](#footnote-ref-308)
310. CUIC § 928.7, 130. [↑](#footnote-ref-309)
311. 171 California Employment Commission v. Butte County Rice Growers Ass’n, 25 Cal. 2d 624 (1945). (I can’t find this note in the text.) [↑](#footnote-ref-310)
312. *Id.* [↑](#footnote-ref-311)
313. *Id.* [↑](#footnote-ref-312)
314. California Employment Stabilization Commission v. Sacramento Valley Walnut Ass’n, 68 Cal. App. 2d 173, 180 (1945). [↑](#footnote-ref-313)
315. Employment Division v. Surata Soy Foods, Inc., 63 Or. App. 221, 224 (1983). [↑](#footnote-ref-314)
316. 294 Or. 295, 656 P.2d 944. [↑](#footnote-ref-315)
317. 2014 WL 7011292 (Minn. App. 2014). [↑](#footnote-ref-316)
318. 81 S.Ct. at 936. [↑](#footnote-ref-317)
319. Builders Commonwealth, Inc. v. Dep’t of Employment and Economic Development, 814 N.W.2d 49, 58 (Minn. App. 2012). [↑](#footnote-ref-318)
320. *Id.* at 58-59. [↑](#footnote-ref-319)
321. *Id*. at 58. [↑](#footnote-ref-320)
322. CUIC § 1256; Kelly v. C.U.I.A.B., 223 Cal. App. 4th 1067 (2014); 22 CCR § 1256-1. [↑](#footnote-ref-321)
323. 22 CCR §§ 1256-7, 1256-30. [↑](#footnote-ref-322)
324. 16C C.J.S. Constitutional Law § 1507. [↑](#footnote-ref-323)
325. CUIC §§ 1086-1089. [↑](#footnote-ref-324)
326. CUIC § 1116. [↑](#footnote-ref-325)
327. Cal. Labor Code § 3351. [↑](#footnote-ref-326)
328. Cal. Labor Code § 3351(c). [↑](#footnote-ref-327)
329. Cal. Labor Code § 3351(f). [↑](#footnote-ref-328)
330. Cal. Labor Code § 3352 (16). [↑](#footnote-ref-329)
331. Cal. Labor Code § 3352 (17). [↑](#footnote-ref-330)
332. Cal. Labor Code § 4150. [↑](#footnote-ref-331)
333. Cal. Labor Code § 3353. [↑](#footnote-ref-332)
334. Cal. Labor Code § 3357. [↑](#footnote-ref-333)
335. Cal. Labor Code § 2750.5 (the ABC test). [↑](#footnote-ref-334)
336. Borello & Sons, Inc. v. Department of Industrial Relations, 48 Cal. 3d *supra* at 353-354. [↑](#footnote-ref-335)
337. Dynamex v. Superior Court*,* 4 Cal. 5th *supra* at 935. [↑](#footnote-ref-336)
338. People v. Riddles, 8 Cal. App. 5th 1248 (2017). [↑](#footnote-ref-337)
339. Yellow Cab Cooperative v. WCAB, 226 Cal. App. 3d 1288; 277 Cal. Rptr. 434 (1991). [↑](#footnote-ref-338)
340. *Id.* at 1296-1297. [↑](#footnote-ref-339)
341. Associated Reforestation Contractors, Inc. v. State of Oregon, Workers’ Compensation Board, 59 Or. App. 348 (1982). [↑](#footnote-ref-340)
342. *Id.* at 353-354. [↑](#footnote-ref-341)
343. *Id.* at 353. [↑](#footnote-ref-342)
344. [Gantt v. Sentry Insurance, 1 Cal. 4th 1083, 1090; 4 Cal. Rptr. 267 (1992).](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1992049454&pubNum=661&originatingDoc=I79a58726e87e11e1b343c837631e1747&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite))  [↑](#footnote-ref-343)
345. *Id.* [↑](#footnote-ref-344)
346. [Turner v. Anheuser–Busch, Inc., 7 Cal. 4th 1238, 1256; 32 Cal. Rptr. 2d 273 (1994).](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=1994157325&pubNum=661&originatingDoc=I79a58726e87e11e1b343c837631e1747&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite))  [↑](#footnote-ref-345)
347. Soules v. Cadam, Inc., 2 Cal. App. 4th 390, 401; 3 Cal. Rptr. 2d 6 (1991). [↑](#footnote-ref-346)
348. Gantt v. Sentry Insurance*,* 1 Cal. 4th, *supra* at 1101. [↑](#footnote-ref-347)
349. [Akers v. Cnty. of San Diego, 95 Cal. App. 4th 1441, 1453; 116 Cal. Rptr. 2d 602: CACI 2430 (2002).](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=Y&serNum=2002116247&pubNum=3484&originatingDoc=I79a58726e87e11e1b343c837631e1747&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Keycite)) [↑](#footnote-ref-348)
350. Cal. Lab. Code §§ 1102.5, 6310; the author litigated a wrongful termination action in tort based on complaints of racial discrimination in the workplace. [↑](#footnote-ref-349)
351. [Unemp. Ins. Code](https://1-next-westlaw-com.proxylib.csueastbay.edu/Link/Document/FullText?findType=L&pubNum=1000224&cite=CAUIS621&originatingDoc=I41216738b67411d9947c9ea867b7826a&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.Category)) § 1256. [↑](#footnote-ref-350)
352. Barendse v. Knappa Water Ass’n, 260 Or. 356, 364 (en banc); 490 P.2d 356 (1971). [↑](#footnote-ref-351)
353. *Id.* [↑](#footnote-ref-352)
354. Gov. Code § 12940. [↑](#footnote-ref-353)
355. Linnton Plywood Ass’n v. U.S., 410 F. Supp 1100, 1107 (D. Or. 1976). [↑](#footnote-ref-354)
356. Bertram v. Danish Creamery Ass’n, 120 Cal. App. 2d 458, 462 (1953). [↑](#footnote-ref-355)
357. Milk Producers v. Campbell, 249 Ark. 354, 358; 459 S.W.2d. 114 (1970). [↑](#footnote-ref-356)
358. Barendse v. Knappa Water Ass’n, 260 Or, *supra* at 366. [↑](#footnote-ref-357)
359. ​​Cal. Corp. Code § 12625(a). [↑](#footnote-ref-358)
360. Cal. Corp. Code § 12625(b). [↑](#footnote-ref-359)
361. Cal. Corp. Code § 12364(a). [↑](#footnote-ref-360)
362. Cal. Corp. Code § 12625(b). [↑](#footnote-ref-361)
363. Cal. Corp. Code §§ 12625(d)–(f). [↑](#footnote-ref-362)
364. Cal. Corp. Code § 12625(g). [↑](#footnote-ref-363)
365. Cal. Corp. Code § 12652. [↑](#footnote-ref-364)
366. Cal. Corp. Code § 12654. [↑](#footnote-ref-365)
367. Cal. Corp. Code § 12654(b). [↑](#footnote-ref-366)
368. Cal. Corp. Code § 12654(a). [↑](#footnote-ref-367)
369. Cal. Corp. Code § 12656(b). [↑](#footnote-ref-368)
370. Cal. Corp. Code § 12656.5(b). [↑](#footnote-ref-369)
371. Cal. Corp. Code §§ 12658(a) and (b). [↑](#footnote-ref-370)
372. Cal. Corp. Code § 12659(a). [↑](#footnote-ref-371)
373. Cal. Corp. Code § 12660(b). [↑](#footnote-ref-372)
374. Cal. Corp. Code § 12660(c). [↑](#footnote-ref-373)
375. Cal. Corp. Code § 12630(a). [↑](#footnote-ref-374)
376. Cal. Corp. Code §§ 12630(b)(1)-(b)(3). [↑](#footnote-ref-375)
377. Cal. Corp. Code § 12631(b). [↑](#footnote-ref-376)
378. Cal. Corp. Code § 12631(c). [↑](#footnote-ref-377)
379. Cal. Corp. Code § 12632(b). [↑](#footnote-ref-378)
380. Cal. Corp. Code §§ 12632(b)(1)-(5). [↑](#footnote-ref-379)
381. Cal. Corp. Code §§ 12638(b)(1)-(4); 12638(c)(1) and (2). [↑](#footnote-ref-380)
382. Cal. Corp. Code § 12633(b). [↑](#footnote-ref-381)
383. Cal. Corp. Code § 12636. [↑](#footnote-ref-382)
384. Cal. Corp. Code § 12634. [↑](#footnote-ref-383)
385. Cal. Corp. Code § 12635. [↑](#footnote-ref-384)
386. Cal. Corp. Code § 12637. [↑](#footnote-ref-385)
387. Cal. Corp. Code §§ 12620(a)(1)-(4). [↑](#footnote-ref-386)
388. Cal. Corp. Code § 12620(b)(1). [↑](#footnote-ref-387)
389. Cal. Corp. Code § 12620(b)(6). [↑](#footnote-ref-388)
390. Cal. Corp. Code § 12620(b)(2). [↑](#footnote-ref-389)
391. Cal. Corp. Code § 12622. [↑](#footnote-ref-390)
392. Cal. Corp. Code § 12620(b)(3). [↑](#footnote-ref-391)
393. Cal. Corp. Code § 12620(d)(2). [↑](#footnote-ref-392)
394. Cal. Corp. Code § 12620(b)(4). [↑](#footnote-ref-393)
395. Cal. Corp. Code § 12620(b). [↑](#footnote-ref-394)
396. Cal. Corp. Code § 12620(d)(1). [↑](#footnote-ref-395)
397. Cal. Corp. Code § 12621(a). [↑](#footnote-ref-396)
398. Cal. Corp. Code §§ 12621(a)(1)-(4). [↑](#footnote-ref-397)
399. Cal. Corp. Code § 12621(b). [↑](#footnote-ref-398)
400. Cal. Corp. Code § 12621(c). [↑](#footnote-ref-399)
401. Cal. Corp. Code § 12621(d). [↑](#footnote-ref-400)
402. Cal. Corp. Code § 12623. [↑](#footnote-ref-401)
403. Cal. Corp. Code § 12624. [↑](#footnote-ref-402)
404. Cal. Corp. Code § 12625(a). [↑](#footnote-ref-403)
405. Cal. Corp. Code § 12625(b). [↑](#footnote-ref-404)
406. Cal. Corp. Code § 12625(c). [↑](#footnote-ref-405)
407. Cal. Corp. Code § 12627(b). [↑](#footnote-ref-406)
408. Cal. Corp. Code § 12627(a). [↑](#footnote-ref-407)
409. Cal. Corp. Code § 12627(c)). [↑](#footnote-ref-408)
410. Cal. Corp. Code § 12627(d). [↑](#footnote-ref-409)
411. Cal. Corp. Code § 12627(e). [↑](#footnote-ref-410)
412. Cal. Corp. Code § 12628(a). [↑](#footnote-ref-411)
413. Cal. Corp. Code §§ 12628(a)(1)-(4). [↑](#footnote-ref-412)
414. Cal. Corp. Code § 12628(b). [↑](#footnote-ref-413)
415. Cal. Corp. Code § 12628(c). [↑](#footnote-ref-414)
416. Cal. Corp. Code § 12629. [↑](#footnote-ref-415)
417. Cal. Corp. Code §§ 12661(b) and (c). [↑](#footnote-ref-416)
418. Cal. Corp. Code § 12662(a)(1)(B). [↑](#footnote-ref-417)
419. Cal. Corp. Code §§ 12662(a)(2)(A) and (2)(B). [↑](#footnote-ref-418)
420. Cal. Corp. Code § 12662(a)(3). [↑](#footnote-ref-419)